Docket for 06-43

No. 06-43
Title: Stoneridge Investment Partners, LLC, Petitioner
v.
Scientific-Atlanta, Inc., et al.
Docketed: July 11, 2006
Lower Ct: United States Court of Appeals for the Eighth Circuit
Case Nos.: (05-1974)
Decision Date: April 11, 2006
Questions Presented

~~Date~~	~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~~~~
Jul 7 2006	Petition for a writ of certiorari filed. (Response due August 10, 2006)
Jul 20 2006	Supplemental brief of petitioner filed.
Jul 20 2006	Waiver of right of respondent Motorola, Inc. to respond filed.
Aug 3 2006	Waiver of right of respondent Scientific-Atlanta, Inc. to respond filed.
Aug 23 2006	DISTRIBUTED for Conference of September 25, 2006.
Sep 20 2006	Response Requested . (Due October 20, 2006)
Oct 19 2006	Brief of respondent Scientific-Atlanta, Inc. in opposition filed.
Oct 20 2006	Brief of respondent Motorola in opposition filed.
Nov 30 2006	Reply of petitioner Stoneridge Investment Partners, LLC filed.
Dec 6 2006	DISTRIBUTED for Conference of January 5, 2007.
Feb 21 2007	DISTRIBUTED for Conference of March 16, 2007.
Mar 19 2007	DISTRIBUTED for Conference of March 23, 2007.
Mar 26 2007	Petition GRANTED. The Chief Justice and Justice Breyer took no part in the consideration or decision of this petition.
Apr 12 2007	The time for filing the joint appendix and petitioner's brief on the merits is extended to and including June 11, 2007.
Jun 5 2007	Consent to the filing of amicus briefs in support of either/neither party received from counsel for the petitioner.
Jun 11 2007	Brief amici curiae of James D. Cox, et al. filed.
Jun 11 2007	Brief amicus curiae of American Council of Institutional Investors filed.
Jun 11 2007	Brief amici curiae of Los Angeles County Employees Retirement Association, et al. filed.
Jun 11 2007	Brief amici curiae of New York State Teachers' Retirement System, et al.filed.
Jun 11 2007	Brief amici curiae of Arkansas, et al. filed.
Jun 11 2007	Brief amici curiae of Change to Win, and CtW Investment Group filed.
Jun 11 2007	Brief amici curiae of Charles W. Adams, and William Von Glahn filed.
Jun 11 2007	Brief amicus curiae of American Association for Justice filed.
Jun 11 2007	Brief amicus curiae of North American Securities Administrators Association, Inc. filed.
Jun 11 2007	Brief amici curiae of AARP, et al. filed.
Jun 11 2007	Brief amicus curiae of Regents of University of California filed.
Jun 11 2007	Brief amici curiae of Ohio, Texas, and 30 other States and Commonwealths filed.
Jun 11 2007	Joint appendix filed. (Statement of costs received)
Jun 11 2007	Brief of petitioner Stoneridge Investment Partners, LLC filed.

Jun 11 2007 Brief amicus curiae of California State Teachers' Retirement System filed.

Jun 19 2007 The time to within which to file respondents' briefs on the merits is extended to and including August 15, 2007.

Jul 16 2007 Motion for leave to file amici brief out of time filed by Former SEC Commissioners .

Jul 18 2007 Opposition of respondents to motion of Former SEC Commissioners to file an amici curiae brief out of time.

Jul 30 2007 Motion for leave to file amici brief by John Conyers, Jr. and Barney Frank out of time filed.

Aug 14 2007 SET FOR ARGUMENT Tuesday, October 9, 2007.

Aug 14 2007 Brief amici curiae of Former SEC Commissioners and Officials and Law and Finance Professors filed.

Aug 14 2007 Record received from U.S.C.A. for 8th Circuit. (1 box) U.S.D.C. for Eastern District of Missouri record is electronically filed.

Aug 15 2007 Brief amicus curiae of Defense Research Institute filed.

Aug 15 2007 Brief amici curiae of American Bankers Association, et al filed.

Aug 15 2007 Brief amicus curiae of United States filed.

Aug 15 2007 Brief amici curiae of Organization for International Investment, et al. filed. (Distributed)

Aug 15 2007 Brief amicus curiae of Chamber of Commerce of the United States of America filed. (Distributed)

Aug 15 2007 Brief amici curiae of Richard I. Beattie, et al. filed. (Distributed)

Aug 15 2007 Brief amici curiae of Securities Industry and Financial Markets Association and Futures Industry Association filed. (Distributed)

Aug 15 2007 Brief amici curiae of American Insurance Association, et al. filed. (Distributed)

Aug 15 2007 Brief amicus curiae of National Association of Manufacturers filed. (Distributed)

Aug 15 2007 Brief amicus curiae of American Institute of Certified Public Accountants filed. (Distributed)

Aug 15 2007 Brief amicus curiae of Washington Legal Foundation filed. (Distributed)

Aug 15 2007 Brief amici curiae of Nasdaq Stock Market, Inc. and NYSE Euronext filed.

Aug 15 2007 Brief amicus curiae of Merrill Lynch & Co., Inc. filed. (Distributed)

Aug 15 2007 Brief amicus curiae of Business Roundtable filed. (Distributed)

Aug 15 2007 Brief of respondents Scientific-Atlanta, Inc., and Motorola, Inc. filed. (Distributed)

Aug 15 2007 Brief amicus curiae of Attorneys' Liability Assurance Society, Inc. filed. (Distributed)

Aug 16 2007 CIRCULATED.

Aug 20 2007 Motion for leave to file amici brief out of time filed by Former SEC Commissioners GRANTED. The Chief Justice and Justice Breyer took no part in the consideration or decision of this motion.

Aug 20 2007 Motion for leave to file amici brief out of time filed by John Conyers, Jr. and Barney Frank GRANTED. The Chief Justice and Justice Breyer took no part in the consideration or decision of this motion.

Aug 24 2007 Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.

Aug 31 2007 Supplemental brief of respondents Scientific-Atlanta, Inc., and Motorola, Inc. filed. (Distributed)

Sep 19 2007 Reply of petitioner Stoneridge Investment Partners, LLC filed. (Distributed)

Sep 19 2007	Record received from U.S.D.C. for Eastern District of Missouri. (2 boxes) This record contains sealed documents. (Remainder of this record is electronically filed)
Sep 20 2007	The Chief Justice is no longer recused in this case.
Sep 25 2007	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED. Justice Breyer took no part in the consideration or decision of this motion.

Supreme Court, U.S.
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06-43 JUL 7 - 2006
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No. 06-

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims for deceptive conduct under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c), where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions.

CORPORATE DISCLOSURE STATEMENT

Petitioner Stoneridge Investment Partners LLC is not a subsidiary of any other corporation and no publicly held corporation owns 10% or more of its stock.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 443 F.3d 987 (8th Cir. 2006). The final judgment of the district court (Pet. App. 12a-14a) is unreported. The district court's memorandum and order (Pet. App. 15a-29a) is unofficially reported at 2004 U.S. Dist. LEXIS 29679, 2004 WL 3826760 (E.D. Mo. Dec. 20, 2004). The district court's memorandum and order (Pet. App. 30a-71a) is unofficially reported at 2004 U.S. Dist. LEXIS 29647, 2004 WL 3826761 (E.D. Mo. Oct. 12, 2004).

STATEMENT OF JURISDICTION

The judgment of the court of appeals was entered on April 11, 2006. This Court has jurisdiction under 28 U.S.C. § 1245(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention

of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * *

Rule 10b-5, 17 C.F.R. 240.10b-5, states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

This is a class action brought on behalf of purchasers of the securities of Charter Communications, Inc. ("Charter") for violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5.

Respondents Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") (collectively, "Respondents"), are alleged to be primary violators of Rule 10b-5(a) and (c) in engaging in a scheme with Charter for the sole purpose of portraying a false picture of Charter's financial performance. This scheme with Respondents was the subject of an indictment by the United States Department of Justice ("DOJ") against two of Charter's officers, as well as a Cease and Desist Order procured by the Securities and Exchange Commission ("SEC") against Charter.

The court of appeals affirmed the district court's dismissal of the claims against Respondents, holding that they were barred by this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). The claims against all defendants other than Respondents were settled.

Charter is one of the country's largest cable television providers. It announced its operating results and projections on a quarterly basis in press releases and conference calls with cable industry stock analysts. Its executives and employees also regularly communicated with stock analysts regarding such information. Two of the primary indicators upon which these analysts relied when evaluating the value of Charter's stock were operating cash flow and revenue. Charter's management viewed success in meeting stock analysts' expectations as critical to determining its stock price.

In or about August 2000, Charter realized that its 2000 year-end operating cash flow would be lower than the amount both

it and its stock analysts had projected. In an effort to generate the $15-20 million in additional revenue needed to meet these critical cash flow projections, Charter directed one of its executives to solicit advertising business from Respondents, who are Charter's largest suppliers of set-top boxes. (Charter's subscribers use set-top boxes to receive television signals.) Respondents rebuffed these solicitations, however. In recognition of the negative impact that a disappointment in meeting analysts' estimates would have on the price of Charter's stock, Charter requested that Respondents enter into a scheme with it which would falsely inflate Charter's publicly reported year-end revenue and operating cash flow in order to artificially inflate Charter's stock price. The simplicity of the scheme was trumped only by its brazenness.

Charter agreed to offer funds to Respondents who would use these funds to purchase advertising from Charter but at no cost to Respondents. Charter offered Respondents an additional $20 for each set-top box that Charter purchased, if Respondents would agree to return that money to Charter by buying advertising in an equivalent dollar amount. No revenue would be justifiably earned because Charter was using its own funds so that Respondents could "purchase" the advertising. The result would be of no real economic benefit to Charter or Respondents. The sole purpose of the scheme was to perpetuate a fraud by artificially increasing Charter's revenue and operating cash flow.

With respect to Respondent Scientific-Atlanta, Charter had in place long-term contracts to purchase set-top boxes at fixed prices. These contracts were entered into in December 1999 and were modified in July 2000. Nonetheless, at Charter's request, Scientific-Atlanta agreed to claim falsely that it was increasing the price of each box by $20 and that it

would return that money to Charter by supposedly buying needed advertising from it.

To give some appearance of legitimacy to the supposed price increase, on August 28, 2000, a Charter senior executive instructed Scientific-Atlanta's Managing Director for North American Sales to fabricate a letter informing Charter that Scientific-Atlanta was raising set-top box prices. Charter emailed Scientific-Atlanta that the "pricing increase notification letter" should include:

> 1. The reason for the price increase and the date (09/01/00) of the increase.
>
> 2. A description of the quantities of set-tops this letter would cover, the anticipated number of set-tops (351,180) that SA [Scientific-Atlanta] expects to ship and Charter expects to take delivery of between 09/01/00 and 12/31/00.
>
> 3. A penalty provision in case Charter doesn't accept the anticipated number of set-tops in the specified time frame.

To round out the scheme, Charter's senior executive also said, "In addition, I will be sending the advertising contract for review prior to the final particulars being worked out."

Immediately after sending these instructions to Scientific-Atlanta, Charter's Vice-President of Advertising Sales was directed to prepare an advertising contract with Scientific-Atlanta worth nearly $6.73 million, the exact amount of the phoney price increase for the set-top boxes.

In accordance with the scheme, on August 31, 2000, Scientific-Atlanta's National Business Manager notified Charter that Scientific-Atlanta was increasing the price for

all set-top boxes scheduled to be purchased by Charter for the balance of 2000. Scientific-Atlanta falsely attributed the price change to "increased manufacturing costs."

The amended contract for the price increase was finalized in late September. Also in late September 2000, Scientific-Atlanta and Charter executed "marketing support" agreements entitled: "Spot Telecasting and Digital Marketing Support Fee Agreements." These agreements set rates in the exact amount necessary to funnel back to Charter the millions of dollars that Charter had agreed to pay for the sham price increase, *i.e.*, Charter agreed to pay $6.73 million more for the boxes than it had previously contracted for and Scientific-Atlanta agreed to pay exactly that same amount for advertising. Moreover, the rates for the advertising were four to five times the amounts ordinarily charged, further indicative of the lack of any genuine business purpose to the transactions.

As noted, the set-top box contract and the advertising contract were not finalized until late September. Nonetheless, to give the appearance that the contracts were not related, Scientific-Atlanta agreed to allow the set-top box contract to be back- dated to August.

With respect to Respondent Motorola, Charter had agreements in place to purchase a stated number of set-top boxes at established prices. In late September, however, Charter finalized a contract to purchase 540,000 "cable set-top boxes" by the end of the year. The size of the order was extraordinary considering that Charter had already contracted to purchase this same number of boxes for the entire twelve months of 2001.

Most significantly, Charter agreed to pay Motorola $20 "liquidated damages" for each unit that it defaulted on buying during the fourth quarter of 2000. In turn, Motorola agreed by contract dated September 29, 2000 to purchase advertising from Charter that it did not need and at inflated rates which totaled $10,800,000, the exact amount of the "liquidated damages" for the 540,000 boxes. As with Scientific-Atlanta, although the new contract to purchase the set-top boxes was not finalized until late September, Motorola agreed to back-date the contract for the set-top boxes to give the false appearance that the contracts were unrelated.

The $17 million in revenue to Charter from these schemes with Respondents was the exact amount Charter needed to cover the shortfall in its true financial results and the results its securities analysts were expecting.

The fraudulent nature of these transactions is aptly summarized by the SECs July 27, 2004 Cease and Desist Order against Charter:

> In reality, no real revenue was generated from these transactions because Charter provided the suppliers with the money they used to purchase the advertising services from Charter. Charter *overpaid* approximately $17 million to the two set-top suppliers and received the same amount back from the two suppliers as advertising revenue in the fourth quarter of 2000. . . .

Respondents understood that pursuant to the scheme, the so-called advertising revenue received from them was to be included in Charter's revenues and operating cash flow for the year 2000. Charter's financial statements containing these fraudulent transactions were distributed to the investing public and filed with the SEC.

Petitioners allege that Respondents violated § 10(b) and Rule 10b-5(a) and (c) by participating in a "scheme or artifice to defraud" and by engaging in a "course of business which operates . . . as a fraud or deceit."

The district court dismissed the claims against Respondent, holding that they were not primary violators of § 10b and Rule 10b-5 as Petitioners had alleged, but rather were aiders and abettors of Charter in its violation of § 10(b). Accordingly, the district court held that the claims against Respondents were barred by this Court's holding in *Central Bank*. The court also denied Petitioners' motion to amend the complaint to plead additional facts on the ground that it would be futile since it was based on the same legal claim which the court found unsustainable.

The court of appeals affirmed the dismissal, ruling that Petitioners' claims were barred by this Court's decision in *Central Bank*, holding that "[a] device or contrivance is not 'deceptive' within the meaning of § 10(b) absent some misstatement or a failure to disclose by one who has a duty to disclose." 443 F.3d at 992. It concluded that absent such a statement or failure to disclose, Respondents' conduct amounted to that merely of aiders and abettors, and that "[t]o impose liability for securities fraud on one party to an arm's length business transaction in goods and services other than securities because that party knew or should have known that the other party would use the transactions to mislead investors in its stock would introduce potential far reaching duties and uncertainties" for such parties. *Id.* at 992-93.

REASONS FOR GRANTING THE PETITION

This Court has consistently recognized that Congress designed § 10(b) of the Securities Exchange Act to prohibit all fraudulent schemes in connection with the purchase or sale of securities, no matter how novel, unique or cunning. The court of appeals committed error by limiting the reach of 10(b) only to certain manipulative securities trading or false and misleading statements. The court of appeals' reliance on *Central Bank* for its holding was misplaced. In *Central Bank* this Court held that there is no private right of action under § 10(b) for those who merely aid and abet a securities fraud by someone else unless they themselves also engaged in fraudulent conduct, since the text of the statute only encompasses fraudulent conduct. But nothing in *Central Bank* changed the prohibition in § 10(b) or Rule 10b-5(a) and (c) concerning "*any*" deceptive conduct.

Whether *Central Bank* altered a long line of decisions in this Court as to the nature of "deceptive" practices captured by § 10(b) is an issue pending in various courts around the country in major securities litigations. Contrary to the decision by the court of appeals in this proceeding, in many of these cases district courts have upheld claims for deception other than the issuance of false and misleading statements. Other courts' decisions are consistent with the court of appeals.

These major securities fraud litigations involve billions of dollars in claims. Consequently, certainty by this Court as to the full reach of § 10(b) is of paramount importance. Without it, whether victims of a fraud may obtain compensation for injuries caused by egregious misconduct depends completely on the forum, and not on the statutory text or this Court's established precedents.

In "'an area that demands certainty and predictability,'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)), there is instead disarray. It is critically important that this Court grant review to provide the needed certainty.

A. The Court of Appeals Disregarded the Statutory Text, Congressional Intent, and Misapplied Long-Established Precedents of this Court

In determining the scope of § 10(b), this Court has instructed that the text is controlling. As stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976): "[W]e turn first to the language of § 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.'" (citation omitted.) *See also Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977).

Under § 10(b), *"any person, directly or indirectly"* is prohibited from using *"any manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b) (emphasis added). Rule 10b-5, promulgated by the SEC, directed against "any person" who engages in broadly described misconduct, provides, in relevant part:

> It shall be unlawful for any person, directly or indirectly . . .
>
> > (a) To employ *any device, scheme or artifice to defraud,*
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

> (c) *To engage in any act, practice, or course of business which* operates or would operate as a fraud or deceit upon any person. . . .

17 C.F.R. § 240.10b-5 (emphasis added).

This Court has consistently found that "[t]he scope of Rule 10b-5 is coextensive with the coverage of § 10(b)." *SEC v. Zandford*, 535 U.S. 813, 1901 n.1 (2002) (citations omitted); *see also Central Bank*, 511 U.S. at 172 (Rule 10b-5 "casts the proscription in similar terms" as § 10(b)); *Ernst & Ernst*, 425 U.S. at 214. The Court has specifically concluded that while Rule 10b-5 liability is premised on the "making of an untrue statement of material fact and the omission of a material fact," subsections (a) and (c) "are not so restricted." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972). Indeed, the "repeated use of the word 'any'" in the statement and the rule is "obviously meant to be inclusive." *Id.* at 151. If the only cognizable deceptive conduct were false statements, as the court of appeals held, Rule 10b-5(a) and (c) would be entirely superfluous.

In *Ernst & Ernst*, this Court emphasized that the words used in § 10(b) must be given their "commonly accepted meaning." 425 U.S. at 199. In this regard, this Court invoked the dictionary definitions of "device" and "contrivance":

> Webster's International Dictionary (2d ed. 1934) defines "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and "contrivance" in pertinent part as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "[t]o

> devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme. . . ."

Id. at 199 n.20 (alterations and omissions in the original). These definitions are broad and inconsistent with a limitation of liability relating only to misleading statements and omissions as the court of appeals held in this case. Significantly, in *Ernst & Ernst*, this Court acknowledged that subsections (b) and (c) of Rule 10b-5 can be read as "proscribing . . . any type of material misstatements or omission, *and any course of conduct*, that has the effect of defrauding investors." 425 U.S. at 212 (emphasis added). Section 10(b) is "a 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.'" *Id.* at 203. *See also Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) (cause of action under § 10(b) and Rule 10b-5 exists where defendants engaged in a fraudulent scheme whereby they misappropriated the proceeds of a corporation's sale of treasury bonds so that one defendant could use those proceeds to pay for all the shares of the same corporation that he had recently purchased).

In again addressing "the reach and coverage of § 10(b)" in *Santa Fe Industries*, 430 U.S. at 464, this Court made it clear that § 10(b) and Rule 10b-5 covered "*deception*, misrepresentation or nondisclosure." *Id.* at 1302 (emphasis added). It found that deception was not limited to misrepresentation or nondisclosure, since it stated the issue in the disjunctive. Indeed, the Court repeatedly focused on "deceptive conduct" as the *sine qua non* of a claim under § 10(b) and Rule 10b-5 rather than merely misleading statements or omissions. *Id.* at 475 n.15. Nevertheless, the court of appeals cited to *Santa Fe Industries* as supporting its narrow interpretation that only false statements are deceptive under the statute.

As this Court has stated: "'We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'" *Superintendent of Ins.*, 404 U.S. at 10 n.7 (quoting *A.T. Brody & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). Congress' intent was to "'insure honest securities markets and thereby promote investor confidence,'" *Zandford*, 535 U.S. at 821 (quoting *United States v. O'Hagan*, 521 U.S. 642, 658 (1977)), as well as to "'achieve a high standard of business ethics in the securities industry.'" *Id.* (quoting *Affiliated Ute Citizens*, 406 U.S. at 151. Thus, § 10(b) is "read flexibly, not technically and restrictively." *Superintendent of Ins.*, 404 U.S. at 12. Indeed, the legislative history reveals Congress' intent to include within § 10(b)'s proscription the very type of conduct implicated here: "the [Senate] Report . . . reveals . . . an overall congressional intent to prevent 'manipulative and deceptive practices which . . . *fulfill no useful function*' and to create private actions for damages stemming from *'illicit practices,'* where the defendant has not acted in good faith." *Ernst & Ernst*, 425 U.S. at 206 (citing to S. Rep. No. 792, 73rd Cong., 2d Sess., at 6 (1934)) (emphasis added); *see also Santa Fe Industries*, 430 U.S. at 473 n.13.

Here, Respondents are alleged to have intentionally engaged in illicit wash or sham transactions, which served "no useful" or legitimate function, for the sole purpose of falsifying Charter's publicly reported financial results. They worked as Charter's partners in the fraudulent scheme to deceive investors and knowingly engaged in acts which were themselves fraudulent. Their illicit acts were inextricably connected to the false statements issued by Charter and were

among the key foundations of one unified fraudulent scheme. Most certainly, Respondents' conduct fits into the "commonly accepted meaning" of the "deceptive device or contrivance" language of § 10(b).

The court of appeals' ruling is not only contradicted by the text of § 10(b) and Rule 10b-5 and this Court's precedents, but is also entirely inconsistent with the legislative intent and history of the statutory scheme.

1. The Court of Appeals Misapplied *Central Bank*

In *Central Bank*, contrary to the ruling of the court of appeals, this Court did not limit the deception prong of § 10(b) to misstatements and omissions. *Central Bank* foreclosed the availability of aiding and abetting liability, but did not decide the full scope of misconduct that creates primary liability. It certainly did not address whether a primary violation can arise from a defendant's engagement in a deceptive scheme or course of conduct under Rule 10b-5(a) and (c), since that issue was not then before the Court.

In *Central Bank*, the plaintiffs had conceded that the defendant did not commit a manipulative or deceptive act, but only assisted another's fraud by failing to insist on the updating of an appraisal that would have revealed the fraud. 511 U.S. at 191-92. Thus, the only issue the Court faced was "the existence and scope of the § 10(b) aiding and abetting action," *id.* at 170, or in other words, whether § 10(b) reached those "who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* at 176. It emphasized that "[i]n any complex securities fraud, . . . there are likely to be multiple [primary] violators," and strongly cautioned that "[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability." *Id.* at 191. They can

be liable "when *all* the requirements for primary liability under Rule 10b-5 are met." *Id.* (emphasis in the original). The Court did not address, far less restrict, the definition of primary liability.

The court of appeals pegged its ruling to a passing reference in *Central Bank* that § 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177. In this *dictum*, the Court did not itemize the full range of acts sufficient to establish primary liability under § 10b-5, since it was addressing conduct self-described by plaintiff as aiding and abetting. It is hardly likely that this Court intended by this statement to abandon the long line of cases discussed above where it recognized the reach of § 10(b) to capture *any* fraudulent act — not merely misstatements. The issue was not before the Court, the parties had not briefed the scope of primary liability, and the courts below had not addressed it. The Court had no reason to address, far less decide, whether the deception prong of § 10(b) only prohibits misstatements or omissions.

Indeed, when this Court's *dictum* is taken in context, it hardly supports the court of appeals' reading of it:

> [W]e again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. *See Santa Fe Industries*, 430 U.S. at 473 ("language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); *Ernst & Ernst*, 425 U.S. at 214 ("When a statute speaks so specifically in terms of manipulation and deception . . . we are quite unwilling to extend the

> scope of the statute"). The proscription does not include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability *for acts that are not themselves manipulative or deceptive* within the meaning of the statute.

Central Bank, 511 U.S. at 177-78 (emphasis added). Thus, just after the *dictum*, this Court cited to two precedents which, as described above, apply the "commonly accepted meaning" of "deceptive device or contrivance," rely on a broad definition, *Ernst & Ernst*, 425 U.S. at 199, and construe that language to prohibit "any *deception*, misrepresentation, or nondisclosure," not just misleading statements or omissions, *Santa Fe Industries*, 430 U.S. at 476 (emphasis added). Significantly, the Court expressly limited its analysis to acts that the parties conceded to be "not themselves manipulative or deceptive," the exact opposite of the situation here. *See* 511 U.S. at 174, 178.

The other cases relied upon by the court of appeals involved claims under Rule 10b-5(b) for misstatements and are inapplicable here. As this Court stated in *Affiliated Ute Citizens*, while Rule 10b-5(b) liability is premised on the "making of an untrue statement of a material fact and the omission to state a material fact," subsections (a) and (c) "are not so restricted." 406 U.S. at 152-53. Similarly, as noted in *In re Parmalat Sec. Litig.* 376 F. Supp. 2d 472, 499 (S.D.N.Y. 2005): "This [misstatement] attribution rule defines the contours of liability for violations of Rule 10b-5(b)" but not the reach of subsections (a) and (c). *See also In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335-36 (S.D.N.Y. 2004) ("[I]n attempting to reduce plaintiffs' arguments to a mere theory of 'fraudulent statement by another name,' [the auditor] itself conflates the distinct

elements of a claim for false statements under subsection (b) of Rule 10b-5 with those of a claim for engaging in fraudulent scheme under subsections (a) or (c)."); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, MDL-1446, Civ. A. No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *91-*92 (S.D. Tex. June 5, 2006) ("*Enron III*"); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 235 F. Supp. 2d 549, 577 (S.D. Tex. 2002) ("*Enron I*").

2. The Court of Appeals Disregarded this Court's Post-*Central Bank* Ruling Reaffirming the Broad Reach of Section 10(b)

SEC v. Zandford, 535 U.S. 813, decided eight years after *Central Bank*, also makes clear that the ruling of the court of appeals is inconsistent with the text of § 10(b) and Rule 10b-5. In *Zandford*, this Court addressed claims under Rule 10b-5(a) and (c) involving a stock broker's sale of customers' securities and use of such proceeds for his own benefit without the customers' knowledge. The Court was not troubled by the fact that the defendant did not make any misstatement. *Id.* at 822. It ruled: "Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' *that conduct*, '*without more*,' was a fraud." *Id.* at 821 (emphasis added) (citation omitted). The Court further stressed that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id.* at 820. The Court also reiterated that "the statute should be 'construed not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Id.* at 819 (citation omitted).

Here, Respondents' deceptive acts represented a "threat to investor confidence in the securities industry," just as much as a misstatement or omission would. *See Zandford*, 535 U.S. at 822.

B. Lower Courts from a Number of Circuits Have Followed the Statutory Text and this Court's Precedents in Acknowledging the Viability of Scheme Liability

Lower courts have recently upheld primary violations of § 10b and Rule 10b-5(a) and (c), for conduct that the court of appeals held not actionable. *See Enron III*, U.S. Dist. LEXIS 43146, at *156-*74; *SEC v. Hopper*, Civ. A. No. H-04-1054, 2006 U.S. Dist. LEXIS 17772, at *36-*40, 2006 WL 778640, at *11 (S.D. Tex. Mar. 24, 2006); *Parmalat*, 376 F. Supp. 2d at 472; *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330 (D. Mass. 2005), *appeal dismissed*, No. 05-2580 (1st Cir. Mar. 29, 2006); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 310 F. Supp. 2d 819 (S.D. Tex. 2004) ("*Enron II*"); *Global Crossing*, 322 F. Supp. 2d at 336-37; *In re AOL Time Warner Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 217 (S.D.N.Y. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003); *Enron I*, 235 F. Supp. 2d at 577. Consistent with this Court's teaching in *Affiliated Ute Citizens*, 406 U.S. at 152-53, these courts found that the misrepresentation and omission proscription contained in Rule 10b-5(b) should not be confused with the scheme and course of conduct liability based on the deception prong of Section 10(b) and the express language of Rule 10b-5(a) and (c). *Cf. In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003), *appeal docketed*, No. 04-55665 (9th Cir. Apr. 16, 2004).

The courts that have recognized the claims under Rule 10b-5(a) and (c) have properly followed the text of § 10b and this Court's precedents and found that deception means more than merely misrepresentations and omissions, but includes a scheme or course of conduct to defraud investors through sham transactions solely designed for the fabrication

of financial statements, even where the defendant itself is not charged with the issuance of the misleading statement or with any duty to disclose facts. For example, in *Parmalat*, the defendant banks were not charged with any misstatements or omissions, or "classic market manipulation." 376 F. Supp. 2d at 492. Instead, their liability was based on their use of fraudulent transactions, *i.e.*, their securitization and factoring of worthless Parmalat invoices which were misreported in Parmalat's statements. *Id.* at 504. In holding that plaintiff had alleged a primary violation of Section 10(b), the court was guided by this Court's broad "instruction on the meaning of the relevant terms in Section 10(b)," i.e., "deceptive device or contrivance," provided in *Ernst & Ernst*. *Id.* at 502 n.151-52. The *Parmalat* court further agreed with the ruling in *Lernout & Hauspie*:

> [T]he better reading of § 10(b) and Rule 10b-5 is that they impose primary liability on any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (*like the creation or financing of a sham entity*) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market.

Id. at 502 (quoting *Lernout & Hauspie*, 236 F. Supp. 2d at 173 (emphasis added)). The court in *Parmalat* adopted this formulation, except for the reference to "substantial participation," explaining that "[t]he text asks only whether a defendant directly or indirectly used or employed a manipulative or deceptive device or contrivance." *Id.* at 503 (footnote omitted).

This is the same conclusion drawn in *Enron I*, *Enron II*, *Enron III*, *Hopper*, *Quaak*, *Global Crossing*, and *AOL Time Warner*. For example, the court in *Enron I* concluded, relying on *Ernst & Ernst* and *Affiliated Ute Citizens*:

> Securities fraud actions under § 10(b) and Rule 10b-5 *are not merely limited to the making of an untrue statement of material fact or omission to state a material fact*. Section 10(b) prohibits "any manipulative or deceptive contrivance," which, as indicated above, the Supreme Court, relying on *Webster's International Dictionary*, includes "a scheme to deceive" or "scheme, plan or artifice." *Ernst & Ernst*, 425 U.S. at 199 n.20. While subsection (b) of Rule 10b-5 provides a cause of action based on the "making of an untrue statement of a material fact and the omission to state a material fact," subsections (a) and (c) "are not so restricted" and allow suit against defendants who, with scienter, participated in "a 'course of business' or a 'device, scheme or artifice' that operated as a fraud" on sellers or purchasers of stock *even if these defendants did not make a materially false or misleading statement or omission. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972).

235 F. Supp. 2d at 577 (emphasis added). Just last month, in *Enron III*, the court rejected the court of appeals' holding, and reaffirmed its prior rulings in *Enron I* and *Enron II*. *See Enron III*, 2006 U.S. Dist. LEXIS 43146, at *173-*174.

C. Scheme Liability is Not Implicated by Arm's Length Transactions

The court of appeals expressed concern in imposing scheme liability on parties engaged in "an arm's length non-securities transaction . . . [where Charter] then used the transaction to publish false and misleading statements. . . ." 443 F.3d at 992-93. But Petitioners made no such claim. Respondents are charged with deliberately participating in a fraudulent scheme and themselves performing such fraudulent acts as back-dating its contracts with Charter. The challenged transactions were not at arm's length, had no valid business or any other legitimate purpose, and were absolute shams transactions. In sum, Respondents themselves engaged in acts that were deceptive and which conduct was inextricably connected to the deception of Charter's investors.

In *Parmalat*, 376 F. Supp. 2d at 492, the defendant banks argued that they merely entered into lawful business deals with a customer, who in turn improperly accounted for the transactions in its financial statements. Therefore, the defendant banks argued, they were at most aiders and abettors. In rejecting this argument, the court emphasized:

> The transactions in which the defendants engaged *were by nature deceptive*. They depended on a *fiction*, namely that the invoices had value. *It is impossible to separate the deceptive nature of the transactions from the deception actually practiced upon Parmalat's investors*. Neither the statute nor the rule requires such a distinction.

376 F. Supp. 2d at 504 (emphasis added). The court further explained that the banks' "regular factoring and securitization of worthless invoices were deceptive devices or contrivances for purposes of Section 10(b). *These were inventions, projects,*

or schemes with the tendency to deceive because they created the appearance of a conventional factoring or securitization operation when, in fact, the reality was quite different." *Id.* (emphasis added). It also pointed out repeatedly that the plaintiff in *Central Bank* had conceded that the defendant had not itself committed a deceptive (or manipulative) act, and "there is nothing in the decision to suggest that *Central Bank* would have escaped liability if it had been found to have committed such an act." *Id.* at 499. It also underscored that the *Central Bank* "decision did not affect the contours of a primary violation of Section 10(b)." *Id.* at 499. *See also SEC v. Hopper*, 2006 U.S. Dist. LEXIS 17772, at *39, 2006 WL 778640, at *11 (The alleged round trip trading scheme in which defendant was involved, included "sham transactions, and therefore had an inherent tendency to deceive" and could constitute "a 'device' or 'scheme' to defraud, or at least a 'practice' or 'course of business' which operated as a fraud or deceit upon the investing public, that encompassed conduct beyond mere misstatements."); *Global Crossing*, 322 F. Supp. 2d at 336-37 ("Schemes used to artificially inflate the price of stocks by creating phantom revenue fall squarely within both the language of section 10(b) and its broad purpose. . . ."); *Enron II*, 310 F. Supp. 2d at 829 ("[A] misrepresentation need not have been made because the statute also applies to conduct, here the alleged substantial, active role *in major fraudulent transactions with no legitimate business purpose*, but designed to deceive investors in and central to a scheme and course of business operating to present a falsely inflated image of Enron's financial strength.") (emphasis added).[1]

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1. The court in *Enron II* also further explained:

> Sham business transactions with no legitimate business purpose that are actually guaranteed "loans" employed

(Cont'd)

The SEC has proposed the following simple test to separate out aiding and abetting conduct from a primary violation:

> Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions That Favor Appellant, *Simpson v. Homestore.com, Inc.*, No. 04-55665 (9th Cir. served Oct. 21, 2004 and filed Oct. 22, 2004), at 16, *also available at* http://www.sec.gov/litigation/briefs/ homestore_ 102104.pdf. The SEC has also provided numerous helpful examples as to how a primary violation can be distinguished from aiding and abetting. If a bank loans money to a person knowing that he will use the loan proceeds to commit securities fraud, the bank's conduct — which is otherwise not manipulative or deceptive — constitutes merely aiding and abetting. This is also true of a third party who enters into a legitimate transaction with a company, knowing that the company will inflate the revenues created by that transaction. A primary violation, however, can be implicated

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(Cont'd)

> to inflate Enron financial image are not above-board business practices. This Court disagrees with Merrill Lynch's contention that the alleged "'deception' did not occur until Enron allegedly misreported" the transactions.

310 F. Supp. 2d at 830.

if the third party and company engage "in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation's stock." SEC *Amicus* Brief, *supra*, at 20. If a third party purchases products from a corporation pursuant to a legitimate contract that includes a right to return the products for a full refund, even with knowledge that the corporation will misreport the transaction as a final sale, the third party is an aider and abettor. But if this third party has a side agreement that no products will actually be shipped to it and it will not pay any monies, with the same awareness, then the third party can be a primary violator. *Id.* at 20-21. Thus, the focus, as the SEC properly makes clear, is on whether the act performed by the third party is itself inherently deceptive, the very conduct alleged in this case.

Moreover, Respondents' conduct was a direct causal connection with the injury to Petitioner and the class of purchasers of Charter's securities. As discussed above, Charter's stock price was driven by its revenue and operating cash flow. Respondents engaged in a fraudulent scheme and course of conduct deliberately intended to inflate those very results. There can be no doubt that the impact of Respondents' deceptive acts on Charter's stock price was not only foreseeable but actually intended. *See Parmalat*, 376 F. Supp. 2d at 509 (although defendants made no misrepresentations, "they knew that the very purpose of certain of their sham transactions was to allow Parmalat to make such misrepresentations," and that defendants' transactions "foreseeably caused losses in the securities market"); *see also Enron II*, 310 F. Supp. 2d at 829-30 (ruling that the sham transactions were "designed to deceive investors in and central to a scheme and course of business operating to present a falsely inflated image of Enron's financial strength"

and strongly disagreeing with the defendant's "contention that the alleged "'deception' did not occur until Enron allegedly misreported" the transactions).

Reliance on Respondents' fraudulent conduct by investors was connected to the injury alleged "even if a material misstatement by another person create[d] the [ultimate] nexus between the scheme and the securities market." *Lernout & Hauspie*, 236 F. Supp. 2d at 173. As the SEC stated in its *amicus* brief, *supra*: "The reliance element should be viewed as satisfied whenever a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiffs securities transaction." *Id.* at 8. As the SEC explained: "Nothing in the rules of causation suggests that only the final act in a scheme to defraud meets the causation requirement." *Id.* at 21. It aptly recognized that "where the making of the false statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation." *Id.* at 22 (citing *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996); *Enron III*, 2006 U.S. Dist. LEXIS 43146, at *173.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT FILED APRIL 11, 2006

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 05-1974

In re: Charter Communications, Inc., Securities Litigation,

Stoneridge Investment Partners, LLS,

Plaintiff - Appellant,

v.

Scientific-Atlanta, Inc; Motorola, Inc.,

Defendants - Appellees.

Submitted: December 12, 2005
Filed: April 11, 2006

Before LOKEN, Chief Judge, WOLLMAN and RILEY, Circuit Judges.

LOKEN, Chief Judge.

This is a securities fraud class action by Stoneridge Investment Partners on behalf of those who purchased Charter Communications, Inc., stock between November 8,

1999 and August 16, 2002. Plaintiffs alleged that Charter—one of the nation's largest cable television providers—engaged in a "pervasive and continuous fraudulent scheme intended to artificially boost the Company's reported financial results" by deliberately delaying the disconnecting of customers no longer paying their bills, improperly capitalizing labor costs, and entering into sham transactions with two equipment vendors that improperly inflated Charter's reported operating revenues and cash flow. Named as defendants were Charter; ten Charter executives during all or part of the class period; Arthur Andersen, LLP, Charter's independent auditor during the class period; and the two equipment vendors, Scientific-Atlanta, Inc., and Motorola, Inc. (collectively, "the Vendors").

Relying on *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), the district court[1] granted the Vendors' motion to dismiss plaintiffs' claims under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the SEC's implementing regulation, Rule 10b-5, 17 C.F.R. § 240.10b-5. The court then denied plaintiffs' motions to reconsider the dismissal and to grant leave to file an amended complaint. Stoneridge appeals. We have jurisdiction because the district court entered a separate final judgment under Rule 54(b) of the Federal Rules of Civil Procedure. We affirm.

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1. The HONORABLE CHARLES A. SHAW, United States District Judge for the Eastern District of Missouri.

Appendix A

I.

1. The Standard of Review. Plaintiffs' sixty-eight-page complaint is factually detailed, as it must be to satisfy the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b). Our de novo review accepts the facts as alleged in the complaint and draws all reasonable inferences in favor of Stoneridge in deciding whether the complaint satisfied these pleading requirements. *See In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 740-48 (8th Cir.2002).

2. The Scheme Alleged. At the time in question, Charter delivered cable services through set-top boxes installed on customers' TV sets. Charter purchased the set-top boxes from third-parties, including the Vendors. In August 2000, although Charter had firm contracts with the Vendors to purchase set-top boxes at a set price sufficient for its present needs, Charter agreed to pay the Vendors an additional $20 per set-top box in exchange for the Vendors returning the additional payments to Charter in the form of advertising fees.

Plaintiffs alleged that these were sham or wash transactions with no economic substance, contrived to inflate Charter's operating cash flow by some $17,000,000 in the fourth quarter of 2000 in order to meet the revenue and operating cash flow expectations of Wall Street analysts. Charter accomplished the deception with fraudulent accounting by improperly capitalizing the increased equipment expenses while treating the returned advertising fees as immediate revenue. Plaintiffs alleged that the Vendors entered into these sham transactions knowing that Charter

intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations. Plaintiffs did not allege that the Vendors played any role in preparing or disseminating the fraudulent financial statements and press releases through which Charter published its deception to analysts and investors.

3. The Governing Law. Section 10(b) makes it unlawful, directly or indirectly, "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

In *Central Bank*, the Supreme Court confirmed that § 10(b) prohibits only "manipulative or deceptive" devices or contrivances, and that private plaintiffs "may not bring a

[Rule] 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." 511 U.S. at 173, 114 S.Ct. 1439. In earlier cases, the Court held that "deceptive" conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-75 & n. 15, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977); *Affiliated Ute Citizens of the State of Utah v. United States*, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972); *accord United States v. O'Hagan*, 521 U.S. 642, 653-655, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997). "Manipulative," as used in the securities context, is a "term of art" and refers to illegal trading practices such as "wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe*, 430 U.S. at 476-77, 97 S.Ct. 1292, citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 & n. 21, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), and *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 43, 97 S.Ct. 926, 51 L.Ed.2d 124 (1977).

Based upon these earlier cases and the text and legislative history of the 1934 Act, the Court in *Central Bank* rejected the contrary position of the SEC and held that Rule 10b-5 does not reach those who only aid or abet a violation of § 10(b):

> As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. . . . The proscription does not include giving aid to a person who commits a manipulative or deceptive act.

511 U.S. at 177, 114 S.Ct. 1439. However, the concluding section of the *Central Bank* majority opinion added an important caveat:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

Id. at 191, 114 S.Ct. 1439 (emphasis in original). This is one of many cases that have tested the boundaries of that caveat.

4. The District Court's Decision. In a thorough Memorandum and Order, the district court concluded that *Central Bank*, as uniformly applied by a number of our sister circuits, precludes plaintiffs' claims against the Vendors as nothing more than claims they aided and abetted Charter in committing § 10(b) violations:

> The Court concludes plaintiffs' claims against [the Vendors] are claims for aiding and abetting. Plaintiffs do not assert that [the Vendors] made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them. Plaintiffs also do

> not allege that [the Vendors] were responsible for, or were involved with the preparation of Charter's allegedly false or misleading financial statements; Charter's allegedly improper internal accounting practices; or the allegedly false or misleading public statements made by Charter and its former executives. Plaintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by [the Vendors]. Instead, plaintiffs contend that [the Vendors] are liable to Charter's investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for.
>
> Nor can [the Vendors] be held liable for any purported omissions as plaintiffs have not alleged that [the Vendors] had any duty to Charter's investors. . . . The Court can find no precedent for the conclusion that business partners, such as [the Vendors], made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue.

Plaintiffs then filed motions for reconsideration and for leave to amend their complaint, citing additional cases and pleading additional facts. The district court denied both motions, concluding that the additional citations were unpersuasive and the proposed amendment would be futile because it merely reiterated the prior allegations with additional particularity.

Appendix A

II.

On appeal, Stoneridge argues that plaintiffs properly alleged a *primary* violation of the securities laws within the meaning of *Central Bank* because the Vendors violated Rule 10b-5(a) and (c) by participating in a "scheme or artifice to defraud" and by engaging in a "course of business which operates . . . as a fraud or deceit." The argument emphasizes that Rule 10b-5(a) and (c) are broadly worded and, unlike Rule 10b-5(b), do not require proof of a fraudulent misrepresentation or failure to disclose. The argument depends on the assertion that *Central Bank 's* analysis did not affect the scope of primary liability under subparts (a) and (c), relying primarily on a recent district court decision, *In re Parmalat Sec. Litig.*, 376 F.Supp.2d 472, 492-503 (S.D.N.Y.2005).

Like the district court, we reject Stoneridge's narrow interpretation of *Central Bank.* We conclude that *Central Bank* and the earlier cases on which it relied stand for three governing principles: (1) The Court's categorical declaration that a private plaintiff "may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)," 511 U.S. at 173, 114 S.Ct. 1439, included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b). (2) A device or contrivance is not "deceptive," within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose. *See Santa Fe*, 430 U.S. at 474- 75, 97 S.Ct. 1292.(3) The term "manipulative" in § 10(b) has the limited contextual meaning ascribed in *Santa Fe*, *id.* at 476-

77, 97 S.Ct. 1292.[2] Thus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5. *Accord Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir.2004); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1204-06 (11th Cir.2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir.1998), *cert. denied*, 525 U.S. 1104, 119 S.Ct. 870, 142 L.Ed.2d 772 (1999); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-27 (10th Cir.1996); *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 n. 3 (9th Cir.1994); *In re Dynegy, Inc. Sec. Litig.*, 339 F.Supp.2d 804, 914-16 (S.D.Tex.2004); *In re Homestore.com, Inc. Sec. Litig.*, 252 F.Supp.2d 1018, 1040-41 (C.D.Cal.2003).

In this case, the focus of plaintiffs' § 10(b) and Rule 10b-5 claims was deception—they alleged a "continuous course of conduct" in which Charter allegedly "made and/or failed to correct public representations which were or had become materially false and misleading regarding Charter's financial results and operations." Indeed, eighteen pages of the amended complaint alleged in fifty detailed paragraphs the fraudulent financial reports and press releases published by Charter during the class period. However, neither

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2. We agree with then-district judge Patrick Higginbotham that the Supreme Court in *Santa Fe* intended to limit § 10(b) claims of unlawful manipulation (as opposed to deception) to "transactions in the [securities] marketplace, the effects of which were to prevent the market price from accurately reflecting the market's unimpeded judgment of the stock's value." *Hundahl v. United Benefit Life Ins. Co.*, 465 F.Supp. 1349, 1360 (N.D.Tex.1979).

Motorola nor Scientific-Atlanta was alleged to have engaged in any such deceptive act. They did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition. None of the alleged financial misrepresentations by Charter was made by or even with the approval of the Vendors. Accordingly, the district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs.

Like the district court and the court in *In re Homestore.com*, 252 F.Supp.2d at 1041, we are aware of no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts. The point is significant. To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.

Appendix A

III.

Finally, Stoneridge argues that the district court abused its discretion in denying plaintiffs' post-dismissal motions to reconsider the dismissal order and to grant plaintiffs leave to amend the complaint. A district court has broad discretion to reconsider an order granting dismissal or summary judgment, but "[a] motion to alter or amend judgment cannot be used to raise arguments which could have been raised prior to the issuance of judgment." *Hagerman v. Yukon Energy Corp.*, 839 F.2d 407, 414 (8th Cir.), *cert. denied*, 488 U.S. 820, 109 S.Ct. 63, 102 L.Ed.2d 40 (1988). Here, plaintiffs argued that the district court overlooked or misapplied prior decisions from district courts in other circuits. The district court briefly reviewed those cases and concluded it "is not inclined to reach a different result." Denial of the motion to reconsider on this ground was not an abuse of discretion. Indeed, we agree with the court's analysis of those non-controlling cases.

The district court denied the post-dismissal motion to amend because the proposed pleading would be futile—the additional allegations as to the Vendors' role and knowledge set forth in the proposed amended complaint did not cure the flaws in plaintiffs' § 10(b) theory. Denial of a motion to amend on this ground, particularly a motion filed after the district court's final ruling, is not an abuse of discretion. *See, e.g., Grandson v. Univ. of Minn.*, 272 F.3d 568, 575 (8th Cir.2001), *cert. denied*, 535 U.S. 1054, 122 S.Ct. 1910, 152 L.Ed.2d 820 (2002).

The Final Judgment of the district court dated February 15, 2005, is affirmed.

APPENDIX B — FINAL JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI, EASTERN DIVISION DATED FEBRUARY 15, 2005

THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

MDL Docket No. 1506 (CAS)
All Cases

Consolidated Case
No. 4:02-CV-1186 CAS

IN RE CHARTER COMMUNICATIONS, INC. SECURITIES LITIGATION

STONERIDGE INVESTMENT PARTNERS LLC, Individually and On Behalf of All Others Similarly Situated,

Plaintiff,

v.

CHARTER COMMUNICATIONS, INC., PAUL ALLEN, JERALD L. KENT, CARL E. VOGEL, KENT KALKWARF, DAVID G. BARFORD, PAUL E. MARTIN, DAVID L. McCALL, BILL SHREFFLER, CHRIS FENGER, JAMES H. SMITH, III and ARTHUR ANDERSEN, LLP,

Defendants.

Appendix B

FINAL JUDGMENT PURSUANT TO FED. R. CIV. P. 54(b) AS TO SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.

WHEREAS, on October 12, 2004, this Court entered an Order, in relevant part, granting defendants Scientific-Atlanta, Inc.'s ("Scientific-Atlanta") and Motorola, Inc.'s ("Motorola") motions to dismiss Count V of the Amended and Consolidated Class Action Complaint; and

WHEREAS, on December 20, 2004, this Court entered an Order, in relevant part, (1) denying plaintiffs' motion to amend to add additional allegations to the complaint detailing the role and knowledge of Scientific-Atlanta and Motorola; and (2) denying plaintiffs' motion for reconsideration of the Court's Order dated October 12, 2004 granting Scientific-Atlanta's and Motorola's motions to dismiss; and

WHEREAS, plaintiffs have filed a motion pursuant to Fed. R. Civ. P. 54(b) seeking to sever the claims against defendants Scientific-Atlanta, Inc. and Motorola, Inc. and requesting that the Court expressly direct the entry of a final judgment thereon; and

WHEREAS, plaintiffs have reached a settlement with all remaining parties to this action; and

WHEREAS, there are no other claims to be adjudicated;

IT IS HEREBY ORDERED ADJUDGED AND DECREED THAT:

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1. There is no just reason for delay in entering final judgment on plaintiffs' claims against defendants Scientific-Atlanta and Motorola.

2. The Court hereby expressly directs that this final judgment pursuant to Fed. R. Civ. P. 54(b) be entered in this action.

3. Plaintiffs' Amended Consolidated Class Action Complaint is dismissed with prejudice against defendants Scientific-Atlanta and Motorola.

4. Plaintiffs' motion for reconsideration of the Court's Order dismissing plaintiffs' Amended Consolidated Class Action Complaint against defendants Scientific-Atlanta and Motorola is denied with prejudice.

SO ORDERED.

DATED: 2/15/05

s/ Charles A. Shaw
CHARLES A. SHAW
UNITED STATES DISTRICT JUDGE

APPENDIX C — MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI, EASTERN DIVISION DATED DECEMBER 20, 2004

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

MDL DOCKET 1506
ALL CASES

Consolidated Case
No. 4:02-CV-1186 CAS

IN RE CHARTER COMMUNICATIONS, INC.,
SECURITIES LITIGATION

STONERIDGE INVESTMENT PARTNERS LLC,
Individually and On Behalf of All Others
Similarly Situated,

Plaintiffs,

v.

CHARTER COMMUNICATIONS, INC., et al.,

Defendants.

MEMORANDUM AND ORDER

This matter is before the Court on Lead Plaintiff's motions to amend the Amended Consolidated Class Action Complaint ("Complaint") and for reconsideration of the

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Court's October 12, 2004 order granting Scientific-Atlanta and Motorola's ("Vendor Defendants") motions to dismiss. The Vendor Defendants have opposed the motion and the motion is fully briefed.

I. BACKGROUND

The Court hereby incorporates into this memorandum and order the factual allegations and applicable law set forth in the Court's October 12, 2004 memorandum and order. Lead plaintiff now moves to (1) amend the Complaint to extend the Class Period by one month to conform with the evidence developed to date, as well as the terms of the Partial Settlement; (2) amend the Complaint to add additional allegations detailing the role and knowledge of Scientific Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") in the fraudulent scheme; and (3) request reconsideration of the Court's October 12, 2004 order to the extent it granted the motions to dismiss filed by Scientific-Atlanta and Motorola.

An agreement in principle has been reached with Charter, its officers and controlling shareholders, to settle claims against these defendants for payment of $144 million in cash and securities. The terms of that agreement are still being negotiated. In the meantime, Lead Plaintiff states it has conducted a review of nearly one million pages of documents produced by Charter and has interviewed key personnel. The discovery focused in part on claims asserted against the non-settling defendants, Arthur Andersen LLP and the Vendor Defendants.

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Lead Plaintiff's claims against the Vendor Defendants arise out of a series of fraudulent swap transactions that occurred during 2000 that were intended to artificially boost Charter's operating cash flow ("OCF") sufficiently to overcome an anticipated $17 million shortfall. The transactions involved Charter's agreement to pay $20 more for each digital converter set top box purchased and the Vendor Defendants' agreement to return these monies to Charter in the form of advertising.

Lead Plaintiff now states that facts elicited during discovery lend support to its claims against the Vendor Defendants, warranting amendment of the Complaint and reconsideration of the Court's dismissal of the claims asserted against them. In particular, plaintiffs state their discovery reveals that the Vendor Defendants had "non-public information" regarding the fraudulent nature of Charter's efforts to generate the appearance of additional revenues and cash flow during the fourth quarter of 2000.

To that end, Lead Plaintiff asserts the following in its Proposed Second Amended Consolidated Class Action Complaint. The Vendor Defendants manufactured and sold equipment that decoded digital cable signals for viewing on television sets. This equipment was typically contained in a box that sat on top of a television set ("set top boxes").

By August 2000, Charter had pre-existing agreements with the Vendor Defendants to purchase significant numbers of set top boxes at agreed upon prices. (Proposed Second Amended Consolidated Class Action Complaint at ¶ 94.) The Scientific-Atlanta agreement, which had been modified in

July 2000, one month earlier, called for the purchase of over 450,000 set top boxes by the end of 2000, and an additional 1 million boxes in 2001-2002. (*Id.* at ¶¶ 95-96.) The price for the boxes was predetermined in the agreement. The Motorola agreement, dated December 7, 1999, called for Charter to purchase 1 million set top boxes over the two-year period 2000-2001, also at prices determined in the agreement. (*Id.* at 94.)

In August 2000, Charter was facing a year-end OCF shortfall of $15 to $20 million. (*Id.* at 91.) In order to cover this shortfall, defendants David Barford and Kent Kalkwarf, Charter's CEO and COO, respectively, instructed John Pietri, Charter's Senior Vice-President of Engineering, to approach Scientific-Atlanta and Motorola and urge them to purchase advertising from Charter. Pietri did so. Both Vendor Defendants initially declined. (*Id.* at ¶ 92.)

On further instruction from his superiors, Pietri then approached the Vendor Defendants with proposals to engage in sham transactions, the sole purpose of which was to generate the appearance of OCF growth for Charter. (*Id.* at ¶ 97.) Charter offered to pay the Vendor Defendants $20 more per set top box for the same amount of boxes that it had previously agreed to purchase. The transactions were to be completed before the end of 2000. In return, the Vendor Defendants agreed to use the additional $20 per box to pay Charter for advertising spots to be aired before the end of the year. (*Id.* at ¶¶ 97-99.) The Vendor Defendants agreed to the sham transactions, despite their knowledge that the advertising rates they were being charged exceeded the market rates by four to five times. (*Id.* at ¶ 106.) As a result,

Charter's OCF was inflated by $17 million for the fourth quarter of 2000. (*Id.* at ¶ 108.)

The direct participants in the scheme included high level personnel of the Vendor Defendants, including Jeffrey Pierce, Director of National Accounts for a division of Motorola; Steve Kaufman, National Business Manager for Scientific-Atlanta; and Tom Nilson, Managing Director for North American Sales for Scientific-Atlanta.

Once the basic terms of the sham transactions were agreed to, the participants set out to create fraudulent documentation. On August 28, 2000, Charter's Pietri e-mailed Nilson, instructing Scientific-Atlanta to notify Charter that the Vendor Defendant was raising the prices of its set top boxes. (*Id.* at ¶ 100.) Charter advised Scientific-Atlanta to fabricate this documentation, because no such increase was planned by Scientific-Atlanta. (*Id.*) Pietri also told Nilson precisely what to state in the letter, including the number of boxes affected, and a penalty provision to ensure that there was a pretext for Charter paying Scientific-Atlanta the precise amount needed to fund the advertising. (*Id.*) In the "pricing increase notification letter," Pietri specifically instructed Nilson to set forth: (1) the reason for the price increase and the date, September 1, 2000, of the increase; (2) a description of the quantities of set tops this letter would cover, i.e., the anticipated number of set tops, 351, 180, that Scientific-Atlanta expected to ship and Charter expected to take delivery of between September 1, 2000 and December 21, 2000; and (3) a penalty provision in the event Charter did not accept the anticipated number of set tops in the specified time frame. Pietri also stated he would be sending the advertising contract

for review prior to the final particulars being worked out. (*Id.* at ¶ 100 .)

Both parties to this agreement knew that the number of boxes covered was the same amount that Charter had locked into a purchase agreement executed a few months earlier. (*Id.* at ¶ 102.) Not only did Scientific-Atlanta know that there was no price increase, but it had already agreed to give Charter a "most favored customer" clause, meaning that Scientific-Atlanta could not impose a price increase without doing so for each of its customers. (*Id.*)

Following this e-mail, Pietri e-mailed Wes Hart, Charter's Vice President of Advertising Sales, copying defendant Barford and other marketing personnel, and requested an advertising contract totaling $6,823,080 for Scientific-Atlanta, the final contract price being $6,730,000). (*Id.* at ¶ 101.)

Consistent with Pietri's instructions, on August 31, 2000, Steve Kaufman of Scientific-Atlanta notified Charter that purportedly due to increased manufacturing costs, Scientific-Atlanta was increasing the price for all set top boxes scheduled to be purchased by Charter for the balance of the year. Scientific-Atlanta understood that this was not true. (*Id.* at ¶ 102.)

Prior to August 2000, Charter had no agreements for spot telecasting with any cable equipment vendors. (*Id.* at ¶ 91.) However, in September 2000, Scientific-Atlanta and Charter, in furtherance of the scheme, entered into marketing support agreements entitled "Spot Telecasting and Digital Marketing

Support Fee Agreements." These were executed on September 15, 2000 by Pietri, and on September 21, 2000 by Scientific-Atlanta. (*Id.* at ¶ 107 .) These agreements were not the product of arms-length negotiations, but rather the product of simple math to determine how best to funnel the millions that Charter had agreed to pay for the sham price increase back to Charter. In fact, the rates that Scientific-Atlanta agreed to pay were four to five times more than the price that other parties had paid Charter for such time slots in 2000. (*Id.* at ¶ 106.) In the end, Charter agreed to pay $6,730,000 more for the boxes it had previously agreed to buy, and Scientific-Atlanta agreed to pay $6,730,000 for advertising well in excess of its market value, which Scientific-Atlanta did not need anyway. (*Id.* at ¶ 101-2.)

Lead Plaintiff further asserts the pattern with Motorola was the same, although the mechanism was more unusual and the impact larger. On August 31, 2000, the same day as the purported increase in price for the Scientific-Atlanta boxes, Jeffrey Pierce of Motorola and Pietri signed a contract whereby Charter agreed to purchase 540,000 set top boxes in the four month period from September 1, 2000 to December 31, 2000. (*Id.* at ¶ 103.) Only eight months earlier Charter had agreed to purchase 1,000,000 set top boxes from Motorola for the entire 24 month period from 2000 to 2001. The 540,000 units represented the total amount of set top boxes that would likely be purchased during the twelve month period of 2001. (*Id.* at ¶ 103.)

Equally startling is the fact that Charter agreed to pay Motorola $20 in liquidated damages for each unit that Charter failed to purchase during the agreed upon four month time

frame. (*Id.*) Thus, it was clearly understood by both parties to this "contract" that Charter had no intention of ever purchasing the additional units. In fact, the cost of such purchases would have been $140 million dollars, which as Motorola could have ascertained from Charter's publicly disclosed financials, Charter did not have on hand. (*Id.* at ¶ 104.) There was clearly no benefit to Charter suddenly accelerating its purchases of these set top boxes. The only benefit to Charter was not to purchase the set top boxes and to funnel the $10,800,000 penalty to Motorola so that Motorola could return the monies to Charter in the form of advertising payments. (*Id.* at ¶ 105.)

On September 29, 2000, Motorola also entered a spot telecast contract with Charter, agreeing to pay $10,800,000 for advertising it did not need, and at rates that were inflated. (*Id.* at ¶ 107.)

As a result of this scheme, Charter overstated its reported OCF by more than $17.5 million for the fourth quarter of 2000. (*Id.* at ¶ 109.) This enabled Charter to meet analyst expectations and to further buoy Charter stock at an artificially inflated price. Charter ultimately restated its results for the year 2000.

Lead Plaintiff seeks to amend the complaint to add the foregoing allegations detailing the Vendor Defendants' participation in, and knowledge of, the fraudulent scheme to inflate Charter's revenues and OCF. Lead Plaintiff argues that the new facts are highly probative of the Vendor Defendants' direct participation in and knowledge of the scheme to defraud investors. They assert there is no other

explanation for the opportunistic price increase, the round tripping of revenues, Charter's willingness to pay a penalty equivalent to the price increase if it did not take shipment of the boxes, and the Vendor Defendants' willingness to pay inflated prices for advertising. Lead Plaintiff states these details came to light only through recent discovery efforts after the motions to dismiss had been briefed and therefore reconsideration of this Court's October 12, 2004 order dismissing the claims against the Vendor Defendants is warranted.

The Vendor Defendants oppose the motion, and each filed a separate response. Motorola argues the new information does nothing to impact this Court's conclusion with respect to *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994). It asserts the "new" facts are merely minor reworkings of the same allegations in the prior complaint. Motorola contends the new facts allegedly relate to Motorola's scienter, even though this Court did not reach that question. Thus, even if the new facts plaintiffs seek to allege were true, this Court's prior decision would remain the same. Motorola further argues Lead Plaintiffs cannot circumvent *Central Bank* by simply asserting the Vendor Defendants were part of a scheme. Motorola also contends the additional decisions cited by Lead Plaintiff do not support plaintiff's position.

In its response, Scientific-Atlanta asserts Lead Plaintiff has not shown any manifest error of law or any other exceptional circumstances that justify relief. It further argues that pleading additional particularity cannot transform it from an aider and abettor into a primary violator of the federal securities laws.

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II. DISCUSSION

The Federal Rules of Civil Procedure do not mention motions for reconsideration. A "motion for reconsideration" which is directed to a non-final order may only be construed as a motion under Rule 60(b). *Broadway v. Norris, 193 F.3d 987* (8th Cir.1999). "[A]s a rule courts should be loathe to [revisit prior decisions] in the absence of extraordinary circumstances such as where the initial decision was 'clearly erroneous and would work a manifest injustice.'" *Christianson v. Colt Indus. Operating Corp.*, 486 U.S. 800, 817, 108 S.Ct. 2166, 100 L.Ed.2d 811 (1988) (quoting *Arizona v. California*, 460 U.S. 605, 618 n. 8, 103 S.Ct. 1382, 75 L.Ed.2d 318 (1983)) (discussing law of the case doctrine). Reconsideration is appropriate to correct manifest errors of law or fact, or to present newly-discovered evidence. *Harsco Corp. v. Zlotnicki*, 779 F.2d 906, 909 (3rd Cir.1985), *cert. denied*, 476 U.S. 1171, 106 S.Ct. 2895, 90 L.Ed.2d 982 (1986) (citation omitted) (concerning motion for reconsideration of summary judgment order). A further basis for a motion to reconsider would be a controlling or significant change in the law or facts since the submission of the issues to the Court. *See e.g. Above the Belt, Inc. v. Mel Bohannon Roofing, Inc.*, 99 F.R.D. 99, 101 (E.D.Va.1983) (motion to reconsider summary judgment order.)

The Court finds that plaintiff's motion pleads additional particularity and merely reiterates in part the allegations of the Complaint, and so fails to meet the cited criteria. Lead Plaintiff cites two cases it believes the Court overlooked in its ruling dismissing the complaint as to the Vendor Defendants, *In re Enron Corp. Sec. Deriv. & ERISA Litig.*,

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310 F.Supp.2d 819 (S.D.Tex.2004) ("Enron II")[1] and *In re Global Crossing, Ltd. Sec. Litig.*, 322 F.Supp.2d 319 (S.D.N.Y.2004).

In *Enron II*, brokerage firm Merrill Lynch moved to dismiss, maintaining Lead Plaintiffs' claims were barred by *Central Bank*. The district court denied Merrill Lynch's motion to dismiss, holding the allegations in the complaint were sufficient to show Merrill Lynch liable as a primary violator under the scheme prong of § 10(b) and Rule 10b-5. The district court acknowledged its rejection of the "narrow construction of the statute and of primary violations employed by *Homestore.com*." *See* 310 F.Supp.2d at 828. The court held Lead Plaintiff alleged with specificity that Merrill Lynch "directly or indirectly" employed a scheme to defraud and engaged in acts, practices, and a course of business over the Class Period, as well as issued numerous analysts' reports and recommendations containing false and misleading statements about Enron's financial condition, as part of the purported Ponzi scheme that was intended to and did operate as a fraud or deceit upon investors in connection with the purchase of Enron securities. Lead Plaintiff made new and specific allegations regarding the Merrill Lynch's deceptive conduct in a Nigerian barge deal which involved

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1. The Court notes that in its memorandum in support of this motion, Lead Plaintiff misquotes a lengthy portion of the *Enron II* decision by failing to indicate where language was omitted. As a result, the passage "quoted" by Lead Plaintiff is not accurate and misleading. In future submissions to the Court, Lead Plaintiff should indicate—through the use of ellipses—where omissions by the writer have been made. *See generally*, *A Uniform System of Citation*, "Omissions," Rule 5.3.

purchasing Nigerian barges from Enron to create sham earnings of over $12 million in return for a secret, oral side agreement with Andrew Fastow that Enron would repurchase them within six months so there would be no risk, but only a lucrative profit for Merrill Lynch. *Id.* at 829. The district court held that such allegations, among others, suggested a strong inference that Merrill Lynch knew the Nigerian barge deal was a phony transaction created to manipulate Enron's income statements in return for Merrill Lynch's lucrative 15% return. *Id.* The district court further noted the complaint alleged an ongoing scheme that Merrill Lynch participated in for years and that resulted in "enormous financial returns for Merrill Lynch officers who personally invested in it as well as lucrative earnings for the company." *Id.* at 830.

In *In re Global Crossing, Ltd. Sec. Litig.*, 322 F.Supp.2d 319, 336 (S.D.N.Y.2004), the district court held outside auditor Arthur Andersen was potentially liable under the scheme prong of Rule 10(b)(5), noting plaintiffs' claims against Arthur Andersen went "far beyond mere aiding and abetting." The court first noted plaintiffs clearly alleged that Andersen "committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud." *Id.* The court then noted the complaint asserted that Andersen "masterminded misleading accounting and sham swap transactions used to circumvent GAAP and inflate the Companies' revenues, that it actively participated in structuring each swap, that it was intimately involved" in all of Global Crossing and Asia Global Crossing's accounting functions, and that it "directly participated" in the creation of misleading "pro forma" numbers that concealed these practices from investors. The court found "Andersen's

allegedly central role in these schemes, as their chief architect and executor, leaves no doubt as to its potential liability as a primary violator under section 10(b)." *Id.*

After reviewing the additional authorities cited by Lead Plaintiffs, the Court is not inclined to reach a different result. Unlike in *Global Crossing* where the court found Andersen the "chief architect and executor" of the alleged schemes, here there are no allegations that the Vendor Defendants had similar involvement with respect to Charter's internal accounting or preparation of its financial statements. In *Enron II*, lead Plaintiff alleged Merrill Lynch issued numerous analysts' reports and recommendations containing false and misleading statements about Enron's financial condition. Lead Plaintiff made no such allegations here. Thus, Lead Plaintiff's motion for reconsideration should be denied.

Likewise, the Court will deny the motion to amend the complaint to add additional allegations detailing the role and knowledge of Scientific Atlanta and Motorola in the fraudulent scheme. Although a pretrial motion for leave to amend is to be liberally granted, different considerations apply to motions filed after dismissal. *Dorn v. State Bank of Stella*, 767 F.2d 442, 443 (8th Cir.1985) (citations omitted). After a complaint is dismissed, the right to amend under Fed.R.Civ.P. 15(a) terminates. *Id., citing Czeremcha v. International Association of Machinists and Aerospace Workers*, 724 F.2d 1552, 1556 (11th Cir.1984). The decision whether to allow amendment of a complaint is. left to the Court's sound discretion. *Anderson v. Alpha Portland Industries, Inc.*, 836 F.2d 1512, 1521 (8th Cir.1988), *cert. denied*, 489 U.S. 1051, 109 S.Ct. 1310, 103 L.Ed.2d 579

(1989). It is appropriate to deny leave to amend where the filing of the amended complaint would be futile. *Humphreys*, 990 F.2d at 1082; *Harbor Insurance Co. v. Essman*, 918 F.2d 734, 739 (8th Cir.1990), *citing Niagra of Wisconsin Paper Corp. v. Paper Industries Union-Management Pension Fund*, 800 F.2d 742, 749 (8th Cir.1986). The Court concludes that in light of the above, amending the complaint would be futile.

Finally, the Court will grant Lead Plaintiff's motion for leave to amend the Complaint to extend the Class Period by one month to conform with the evidence developed to date, as well as the terms of the Partial Settlement.

Accordingly,

IT IS HEREBY ORDERED that Stoneridge Partners, LLC's motion to amend or correct is **GRANTED in part and DENIED in part**. (Doc. 264.) The motion is denied to the extent it seeks to add additional allegations to the complaint detailing the role and knowledge of Scientific Atlanta and Motorola in the fraudulent scheme. The motion is granted to the extent it extends the Class Period by one month to conform with the evidence developed to date and the terms of the Partial Settlement.

IT IS FURTHER ORDERED that Stoneridge Partners, LLC's motion for reconsideration is **DENIED**. (Doc. 264.)

IT IS FURTHER ORDERED that Scientific-Atlanta's motion for leave to file a supplemental memorandum in support of its motion to amend the complaint and to reconsider dismissal of claims is **DENIED**. (Doc. 272.)

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IT IS FURTHER ORDERED Lead Plaintiff shall file an amended complaint extending the Class Period by one month to conform with the evidence developed to date and the terms of the Partial Settlement by January 3, 2005.

s/ Charles A. Shaw
CHARLES A. SHAW
UNITED STATES DISTRICT JUDGE

Dated this 20th day of December, 2004.

APPENDIX D — MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI, EASTERN DIVISION DATED OCTOBER 12, 2004

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

MDL DOCKET 1506
ALL CASES

Consolidated Case
No. 4:02-CV-1186 CAS

IN RE CHARTER COMMUNICATIONS, INC.,
SECURITIES LITIGATION

STONERIDGE INVESTMENT PARTNERS LLC,
Individually and On Behalf of All Others
Similarly Situated,

Plaintiffs,

v.

CHARTER COMMUNICATIONS, INC., et al.,

Defendants.

MEMORANDUM AND ORDER

This matter is before the Court on several motions to dismiss for failure to state a claim. Plaintiffs oppose the motions and the matter is now fully briefed. The Court will

grant the motion as to Scientific-Atlanta and Motorola, and deny the motion as to Arthur Andersen for the reasons set forth below. The Court will also enter the protective order submitted by the parties.

I. BACKGROUND

Charter Communications, Inc. ("Charter") is a cable operator that provides video, data, interactive and private business network services to customers in forty states through the company's broadband network of coaxial and fiber optic cable. The company offers traditional analog cable as well as digital television services, along with an array of advanced products and services such as high-speed Internet access, interactive video programming and video-on-demand.

This is a putative securities class action filed on behalf of investors who purchased Charter securities during the period from November 8, 1999 through July 17, 2002 (the "Class Period"). In addition to Charter, plaintiffs named as defendants current and former senior executives, Arthur Andersen LLP, an accounting firm headquartered in Chicago, Illinois, which served as Charter's independent auditor during the Class Period; and Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola"), two of Charter's vendors that manufacture electronic equipment, including digital set-top boxes used in the cable industry.

Upon motion of several of the parties, the Court temporarily stayed the proceedings so that the parties could pursue mediation. The parties who participated in the mediation reached a tentative agreement that is subject to

the Court's approval. Prior to the stay, Scientific-Atlanta, Motorola,[1] and Arthur Andersen—who are not parties to the tentative settlement—moved to dismiss the amended complaint for failure to state a claim upon which relief can be granted under Federal Rules 12(b)(6) and 9(b), and the Private Securities Litigation Reform Act of 1995 ("PSLRA" or "Reform Act"), 15 U.S.C. § 78u-4(b). These motions are now before the Court.

In their Amended Consolidated Class Action Complaint ("Amended Complaint"), plaintiffs allege, *inter alia*, defendants (1) engaged in a fraudulent scheme to artificially boost the company's customer base and reported financial results; (2) inflated Charter's internal customer growth rate by deliberately delaying "disconnects" for over 100,000 customers who were no longer paying their bills or who had advised the company they wished to terminate their service; and (3) materially inflated Charter's operating cash flow by improperly capitalizing labor-related and other costs that should have been expensed.

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1. The plaintiffs' allegations as to Motorola and Scientific-Atlanta are pled collectively as to both defendants. While Scientific-Atlanta and Motorola filed separate motions to dismiss, Motorola adopts Scientific-Atlanta's arguments to the extent they are applicable to Motorola.

Appendix D

II. DISCUSSION

A. Pleading Standard under PSLRA

A motion to dismiss will not be granted unless it "appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). In considering a motion to dismiss for failure to state a claim upon which relief can be granted under Federal Rules of Civil Procedure 12(b)(6) and 9(b), this Court must view the factual allegations in the light most favorable to the plaintiff. *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 546 (8th Cir.1997). The facts alleged in the complaint are assumed to be true. *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 738 (8th Cir.2002).

"Complaints brought under Rule 10b-5 and section 10(b) are governed by special pleading standards adopted by Congress in the [Reform Act]. These pleading standards are unique to securities and were adopted in an attempt to curb abuses of securities fraud litigation." *Navarre Corp.*, 299 F.3d at 741. Congress enacted two heightened pleading requirements in the Reform Act. First, the Reform Act requires the plaintiff's complaint to specify each misleading statement or omission and specify why the statement or omission was misleading. 15 U.S.C. § 78u-4(b)(1) (Supp. IV 1998). If the allegation "is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Id.* Similarly, Rule 9(b) of the Federal Rules of Civil Procedure has long required that "in all averments of fraud or mistake, the circumstances constituting

fraud or mistake shall be stated with particularity." The text of the Reform Act was designed "to embody in the Act itself at least the standards of *Rule 9(b)*." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 193 (1st Cir.1999).

Second, Congress stated in the Reform Act that a plaintiff's complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u4(b)(2); *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 654 (8th Cir.2001). The Reform Act requires the court to dismiss the complaint if these requirements are not met. 15 U.S.C. § 78u-4(b)(3). In the securities fraud context, this Court must "disregard 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements of the [Reform Act]." *Green Tree*, 270 F.3d at 660. "[U]nder the Reform Act, a securities fraud case cannot survive unless its allegations collectively add up to a strong inference of the required state of mind." *Green Tree*, 270 F.3d at 660. "Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss. While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable. . . . Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and 'strong' inferences." *Id.* (quoting *Greebel*, 194 F.3d at 195-96) (alterations in original).

Plaintiffs brought causes of action under § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5(b)

promulgated thereunder. Section 10(b) of the Exchange Act states in relevant part:

> It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 implements this statute, stating:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

> (c) To engage in any act, practice or course of business which operated or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

B. Scientific-Atlanta and Motorola

According to the Amended Complaint, Scientific-Atlanta is headquartered in Lawrenceville, Georgia and is a leading manufacturer of products for the cable television industry. It designs, develops, and manufactures innovative products which it sells to several cable system operators, also known as "Multiple System Operators" ("MSOs"), one of which is Charter. Motorola is based in Schaumberg, Illinois, and is also one of the country's leading manufacturers of electronic equipment, including products for the cable television industry.

The MSOs use products from Scientific-Atlanta and Motorola, who are primary competitors, as well as other vendors, to distribute video and other services to their consumer cable subscribers. One of the products that Scientific-Atlanta and Motorola manufacture and distribute to the MSOs is a "digital set-top," a unit that is typically placed on top of a television set to enable the customer to access digital cable television and other digital services. Charter purchases this equipment and supplies it to its customers so they can view Charter's cable television programs. In 2000, the digital set-top was a relatively new product, and cable operators such as Charter marketed its new features to prospective and existing cable customers.

Appendix D

Plaintiffs assert that Charter entered into sham arrangements with Motorola and Scientific-Atlanta intended to boost Charter's revenues and operating cash flow. In order to provide digital cable television service, it was necessary for Charter to purchase digital cable converter boxes for installation in customers' homes. The purchases of these digital cable converter boxes became a large capital expense for Charter and made Charter an important customer of Scientific-Atlanta and Motorola, the two largest manufacturers of such converter boxes and other equipment used by cable companies. (Am. Compl. at ¶ 75.)

In August 2000, defendants Kent D. Kalkwarf, former Executive Vice President and Chief Financial Officer, and David G. Barford, former Executive Vice President and Chief Operating Officer, realized that Charter was facing a year-end shortfall in operating cash flow relative to amounts projected by Charter and those analysts who covered the company. In order to cover that shortfall, Charter entered into sham agreements for "advertising" from Scientific-Atlanta and Motorola to inflate Charter's operating cash flow for the fourth quarter of 2000. (*Id.* at ¶ 76.) As part of the sham transactions, Charter agreed to pay Scientific-Atlanta and Motorola an additional $20 for each digital converter so long as suppliers repaid that same amount to Charter in the form of "advertising." (Emphasis in Amended Complaint). Thus, the price increases paid by Charter and "advertising" payments made by the vendors constituted "wash" transactions with no economic substance. (*Id.* at ¶ 77.)

Although these sham agreements could have no legitimate effect on Charter's operating cash flow, defendants

exploited such transactions by fraudulently accounting for them in such a way as to significantly and artificially inflate Charter's operating cash flow during the Class Period, by treating the "payments" from Scientific-Atlanta and Motorola as "revenues" when in fact they were simply the return of Charter's own monies. (*Id.* at ¶ 78.)

On the other hand, Charter avoided any adverse effect or decrease on its operating cash flow by capitalizing the payments made to Scientific-Atlanta and Motorola, under the pretext that they were related to the purchase of equipment. Thus, although the advertising payments had no economic effect whatsoever on Charter, through their misleading and fraudulent accounting for the transactions, the defendants used them to artificially increase Charter's publicly disclosed operating cash flow by at least 17 million dollars during the fourth quarter of 2000. But for this scheme, Charter's reported revenues and operating cash flow would have fallen short of analyst expectations. (*Id.* at ¶ 79.)

Plaintiffs assert Scientific-Atlanta and Motorola agreed to such sham transactions knowing or recklessly disregarding that Charter intended to inflate its reported results by recording the monies it received as revenues, while recording monies it paid to them as capital expenses. Plaintiffs assert Scientific-Atlanta and Motorola also knew that analysts would be relying upon such reported amounts in making their recommendations on Charter's stocks. (*Id.* at ¶ 196.) They further allege that by virtue of such conduct, Scientific-Atlanta and Motorola made materially misleading statements to Charter investors knowing or recklessly disregarding that such statements were false or misleading, in violation of

§ 10(b) and Rule 10b-5(b). (*Id.* at ¶ 197.) Alternatively, plaintiffs claim that these sham transactions constituted a "device, scheme, or artifice to defraud" and "an act, practice or course of business which operate[d] . . . as a fraud or deceit" upon Charter investors in violation of Rule 10b-5(a) and (c). (*Id.* at ¶ 198.)

In support of their motions, Scientific Atlanta and Motorola argue that plaintiffs' claims amount to aiding and abetting liability under § 10(b) and Rule 10b-5, and are therefore barred by the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994). They further maintain plaintiffs have failed to plead the required elements to state a claim for primary liability under any subpart of § 10(b) or Rule 10b-5. They also contend the Amended Complaint fails to satisfy the pleading requirements of the PSLRA because it fails to specify each statement attributed to them that is alleged to be misleading and the reason or reasons why the statement is misleading. Finally, they argue plaintiffs have failed to plead the strong inference of scienter to "deceive, manipulate or defraud" Charter's investors as required under the Reform Act.

The Court concludes that plaintiff's claims against Scientific-Atlanta and Motorola amount to claims for aiding and abetting liability under § 10(b) and Rule 10b-5. Under any subsection of those provisions, plaintiffs' claims against these defendants are barred by the Supreme Court's decision in *Central Bank. Central Bank* held that "there is no private aiding and abetting liability under § 10(b)" of the Exchange Act. *Id.* at 191. The Supreme Court examined the text of the

Exchange Act and concluded that Congress did not intend to impose secondary liability under section 10(b). *Id.* at 184. The Court also observed that allowing recovery for aiding and abetting would permit plaintiffs to circumvent the reliance element of a Rule 10b-5 claim—a requirement that places "careful limits" on recovery under Rule 10b-5. *Id.* at 180.

Although aiding and abetting liability was a frequently used basis for derivative liability prior to *Central Bank*, since then, consistent with *Central Bank*, courts have declined to imply aiding and abetting liability or other forms of derivative liability. *Central Bank* left open the possibility of aiding and abetting liability to individuals who had been held liable before, such as accountants and attorneys, as primary violators of § 10(b). In *Anixter v. Home-Stake Production Co.*, the Tenth Circuit similarly held that *Central Bank* precludes liability for secondary actors under Section 10(b) unless they "themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors." 77 F.3d 1215, 1226 (10th Cir.1996). "The critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or by omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations made by another cannot itself form the basis of liability. *Id.* at 1225, citing *Central Bank*. Moreover, in *Wright v. Ernst & Young*, 152 F.3d 169, 175 (2d Cir.1998), the Second Circuit stated that "if Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter

how substantial that aid may be, it is not enough to trigger liability under Section 10(b)." *Id.* (internal citations omitted).

The Court concludes plaintiffs' claims against Scientific-Atlanta and Motorola are claims for aiding and abetting. Plaintiffs do not assert that Scientific-Atlanta and Motorola made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them. Plaintiffs also do not allege that Scientific-Atlanta or Motorola were responsible for, or were involved with the preparation of Charter's allegedly false or misleading financial statements; Charter's allegedly improper internal accounting practices; or the allegedly false or misleading public statements made by Charter and its former executives. Plaintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by Scientific-Atlanta or Motorola. Instead, plaintiffs contend that Scientific-Atlanta and Motorola are liable to Charter's investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for.

Nor can these defendants be held liable for any purported omissions as plaintiffs have not alleged that Scientific-Atlanta or Motorola had any duty to Charter's investors. *See Chiarella v. United States*, 445 U.S. 222, 235, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980) (there can be no liability for fraud under Section 10(b) absent a duty to speak). Plaintiffs allege that by virtue of their conduct, Scientific-Atlanta and Motorola made materially misleading statements to Charter investors knowing or recklessly disregarding that such statements were false or misleading. The Court can find no

precedent for the conclusion that business partners, such as Motorola and Scientific-Atlanta, made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue.

In re Homestore.com Inc. Sec. Litig., 252 F.Supp.2d 1018, 1038 (C.D.Cal.2003), is instructive. In *Homestore* the district court dismissed the complaint, holding that third-party vendors and other business partners were not liable under § 10(b) where plaintiffs failed to allege that they relied on any statements made by those defendants or on the purported "scheme" in which the defendants were alleged to have participated. The *Homestore* court gave three reasons for rejecting plaintiff's theory of liability as to the outside defendants. First, the parties did not cite, nor was the court aware of any case that had ever held a simple business partner to a corporation liable to the shareholders of that corporation for securities fraud. *Id.* at 1037. Second, regardless of how "scheme" is defined, *Central Bank* permits liability only for actors who commit "primary violations" of the securities laws, not "those who merely facilitate or participate." *Id.* at 1038. Third, Homestore shareholders were damaged by reliance on statements and material omissions made by Homestore, not by the "scheme" itself. *Id.* Finally, the court noted that in the cases cited to it following *CentralBank* where an "outsider" had been held liable as a primary violator, the outsider had a special relationship with the corporation, such as accountant or auditor. Thus, these were the kinds of "secondary actors" the Supreme Court in *Central Bank*

foresaw as primary violators. *Id.* at 1039. *Homestore* further stated:

> [T]he language of the Supreme Court does not suggest, and the subsequent case law does not support, the notion that a business partner with no special relationship with a corporation, let alone its shareholders, can be held liable for the material misstatements or omissions of that corporation or its officers, no matter how much it assisted or participated in transactions that led to that statement or omission. Such a holding would broaden the securities acts as to haul into court anyone doing business with a publicly traded company.

Id. at 1039.

Courts have also rejected attempts to characterize such claims as a "scheme to defraud." The *Homestore* court defined a scheme within the meaning of the Exchange Act and the PSLRA as involving "one or more participants acting together to violate securities laws" all of whom "may have varying degrees of culpability depending on their role in the scheme." *Id.* at 1040. Nonetheless *Homestore* held that in light of *Central Bank*, only participants who are primary violators of § 10(b) may be held liable in a private action for securities fraud. *Id.*

Plaintiffs maintain *Homestore* is distinguishable because it involved the actual exchange of services that had real value for the parties regardless of how Homestore treated the

transactions, unlike here where the added price to the transaction had no economic benefit for any of the parties. They further maintain the fact that these defendants did not directly "make" any of the earnings statements issued by Charter does not protect them from liability. Plaintiffs argue that both Scientific-Atlanta and Motorola knowingly or recklessly participated in a fraudulent kickback scheme, the sole purpose of which was to enable Charter, as a valued customer, to inflate its publicly reported revenues and stock price. Therefore, they argue liability for such misconduct falls within Rule 10(b)-(5).

Plaintiffs principally rely on *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F.Supp.2d 549, 577 (S.D.Tex.2002). In *Enron*, plaintiffs claimed Enron's lawyers, accountants and underwriters participated with the company in a "Ponzi" scheme for their own enrichment which, in an essential part of the plan, resulted in defrauding third-party investors in order to keep funds flowing into the company. The complaint specifically claimed that secondary actors caused Enron to violate SEC rules and Generally Accepted Accounting Principles in order to inflate corporate assets, shareholder equity and net income, while at the same time understating company debt.

The *Enron* court found that primary securities fraud allegations were sufficiently stated against several secondary actors, including the company's outside law firm, its auditor and commercial and investment banks. The court adopted the SEC's proposal for primary liability of a secondary party under Rule 10b-5. *Id.* at 590. The SEC proposed, "when a person, acting alone or with others, creates a

misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter." "Moreover, it would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator. Provided that a plaintiff can plead and prove scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else." Also, "a person who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document. Even assuming such a person knew of misrepresentations elsewhere in the document and thus had the requisite scienter, he or she would not have created those misrepresentations." The plaintiff, must of course, plead and prove the elements of scienter and reliance. *Enron*, 235 F.Supp.2d at 583-91 (internal citations omitted.)

Here plaintiffs allege that it was foreseeable to defendants that these transactions would have the intended effect of inflating Charter's revenues and stock price, and as such, defendants knowingly or recklessly engaged in a scheme or artifice designed to defraud Charter investors. Plaintiffs argue this situation is like *Enron* because defendants' alleged kickbacks with Charter had no purpose other than to deceive investors about Charter's true financial condition. The arrangements were meaningful only insofar as they advanced illegitimate ends of an important customer of those defendants.

Appendix D

Scientific-Atlanta and Motorola counter that under *Enron* defendants must have created a misrepresentation upon which investors relied. They argue that they did not create or participate in the creation of Charter's accounting, financial statements, public filings or public statements. They contend that plaintiffs have not alleged that they directed, or even knew of, Charter's accounting treatment. They note that in *Enron* the bank JP Morgan was alleged to have possessed non-public financial information about Enron that would have demonstrated that the transactions in which it was involved were fraudulent. They further note that here plaintiffs have not alleged, nor can they allege that these defendants possessed any non-public information about Charter's financials or its accounting practices, and that these defendants had the ability to verify the accuracy of Charter's public statements. Scientific-Atlanta and Motorola also contend they made no public representations about Charter and that no Charter investor relied on anything they said. Finally, they note that other third parties who transacted business with Enron, such as the law firm of Kirkland & Ellis, as well as Lehman Brothers and Bank of America, were dismissed for failure to state a claim.

This Court does not find *Enron* on point. To reiterate, *Enron* held that § 10(b) liability may only be imposed for secondary actors who have created a document containing a misrepresentation upon which investors relied. The Amended Complaint does not allege that Scientific-Atlanta or Motorola created or participated in the creation of any of Charter's accounting, financial statements, public filings or public statements, nor does it allege that they directed, or even knew of, Charter's accounting treatment. The plaintiffs also do not

allege Scientific-Atlanta and Motorola made public representations about Charter or that any Charter investor relied on anything Scientific-Atlanta and Motorola said. The Court concludes that plaintiffs' claim fails as neither Scientific-Atlanta nor Motorola made a representation to Charter's investors nor participated in the drafting of statements Charter made to its investors.

The Court concludes for the above reasons that plaintiffs' claims against defendants Scientific-Atlanta and Motorola are barred by *Central Bank of Denver. N.A. v. First Interstate Bank of Denver, N.A.*, The parties have not provided, nor has the Court found, any precedent holding a business partner to a corporation, such as Scientific-Atlanta and Motorola here, liable to the investors of that corporation for securities fraud. As the Court finds that plaintiffs' claims are precluded as to Scientific-Atlanta and Motorola as a matter of law, the Court need not address the sufficiency of the Amended Complaint as to these defendants.

C. Arthur Andersen, LLP

Arthur Andersen, LLP ("Andersen"), Charter's outside auditor during the Class Period, moves to dismiss Count IV of the Amended Complaint for failure to state a claim. The PSLRA's pleading requirements do not distinguish between corporate defendants and accountants. Therefore, although the factual allegations against Andersen in the Amended Complaint must be separately considered, the pleading principles set forth above apply equally to the allegations against an accounting firm such as Andersen. *In re MicroStrategy, Inc. Sec. Litig.*, 115 F.Supp.2d 620, 650

(E.D.Va.2000). After reviewing the Amended Complaint and drawing all inferences in favor of plaintiffs as the Court must do in reviewing a motion to dismiss, the Court finds that the plaintiffs have satisfied the heightened pleading standards of the PSLRA.

"Scienter means the intent to deceive, manipulate, or defraud." *Green Tree*, 270 F.3d at 653 (internal quotations omitted). Although the Reform Act's heightened pleading rules require a showing of a "strong inference" of scienter, Congress did not codify any particular methods of satisfying that requirement. *Kushner v. Beverly Enters.*, 317 F.3d 820, 827 (8th Cir.2003). The Eighth Circuit holds that the Reform Act was not intended to alter the substantive nature of the scienter requirement, and therefore its prior case law on the issue remains instructive for this Court. *Green Tree*, 270 F.3d at 653 & n. 7.

As a general rule, inferences of scienter tested under the Reform Act will not survive a motion to dismiss if they are only reasonable inferences-the inferences must be " 'both reasonable and strong.' *"Helwig v. Vencor, Inc.*, 251 F.3d 540, 551 (6th Cir.2001) (en banc) (quoting *Greebel*, 194 F.3d at 195-96), *cert. dismissed*, 536 U.S. 935, 122 S.Ct. 2616, 153 L.Ed.2d 800 (2002). Other circuit case law suggests that a strong inference of the required scienter may arise where the complaint sufficiently alleges that the defendants (1) benefitted in a concrete and personal way from the purported fraud, (2) engaged in deliberately illegal behavior, (3) knew facts or had access to information suggesting that their public statements were not accurate, or (4) failed to check information they had a duty to monitor.

See Kushner, 317 F.3d at 827, citing *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir.), *cert. denied*, 531 U.S. 1012, 121 S.Ct. 567, 148 L.Ed.2d 486 (2000). The Eighth Circuit considers how other circuits have interpreted the strong-inference-of-scienter language as valuable guidance about what factors help to establish such an inference, but takes care to use subsidiary formulae as an aid to interpreting the strong-inference standard and not as a substitute for it. *Navarre*, 299 F.3d at 746 (internal quotations omitted).

Scienter may also be demonstrated by recklessness. *Kushner*, 317 F.3d at 828; *Green Tree*, 270 F.3d at 653. Scienter may be established by severe recklessness involving "highly unreasonable omissions or misrepresentations" amounting to "an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *K & S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 978 (8th Cir.1991) (internal quotations omitted), *cert. denied*, 505 U.S. 1205, 112 S.Ct. 2993, 120 L.Ed.2d 870 (1992). Recklessness, then, may be shown where unreasonable statements are made and the danger of misleading plaintiffs is so obvious that the defendant must have been aware of it. *Id.* "[S]ecurities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements." *Novak*, 216 F.3d at 308. Also, recklessness is shown where alleged facts demonstrate that the defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud. *Id.*

Appendix D

According to the Amended Complaint, Andersen served as Charter's independent auditors throughout the Class Period. In that capacity, Andersen performed audits of Charter's books, records, and financial statements for the years 1999, 2000, and 2001. Plaintiffs allege that Andersen violated § 10(b) and Rule 10b-5 in auditing the financial statements prepared by Charter.

Plaintiffs allege that as Charter's auditor, Andersen had full access to its books, records and personnel, and knew, or recklessly disregarded, that (a) Charter's capitalization rate was the highest in the industry, and resulted from Charter's improper capitalization of costs that should have been expensed; (b) Charter had a pattern of holding disconnects, which contributed to a significant rise in account receivables that should have been promptly written off; (c) Charter improperly accounted for other matters, such as including all launch fees paid by program providers at the initial rate of a contract, rather than over the entire term of the contract; and (d) though aware that Charter was seeking to boost its revenues by paying vendors higher prices at the same time it received additional advertising from the same vendors, Andersen failed to properly audit these transactions by confirming them with the vendors. (Amended Complaint at ¶ 193.)

Plaintiffs specifically allege that following such audits, Andersen issued opinion letters stating that its audits of Charter's financial statements had been conducted in conformance with Generally Accepted Auditing Standards

("GAAS"),[2] and that the statements conformed with Generally Accepted Accounting Principles ("GAAP").[3] (*Id.* at ¶ 191.) Andersen issued a "Report of Independent Public Accountants" with respect to Charter's financial statements for the years 1999, 2000, and 2001 in which Andersen stated that it had conducted its audits in accordance with GAAS and that Charter's financial statements were fairly presented in conformity with GAAP. (*Id.* at ¶¶ 100, 113, 138, 191.) Plaintiffs asserts that Andersen's statements about GAAP and GAAS were false and misleading (*Id.* at ¶¶ 95, 192), resulting in major financial restatements for 2000 and 2001. (*Id.* at ¶¶ 154-55.)

On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. Charter acknowledged for the first time that its "operating cash flow," otherwise known as earnings before interest, taxes, depreciation and amortization ("EBITDA"), had been inflated by 19.5% ($292 million) for the year 2001, and by 14.5% ($195 million) for

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2. GAAS are the standards prescribed by the Auditing Standards Board of the American Institute of Certified Public Accountants for the conduct of auditors in the performance of an examination. *See In re Ikon Office Solutions, Inc.*, 277 F.3d 658, 663 (8th Cir.2002), cited in *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 n. 2 (9th Cir.1979).

3. GAAP is "a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time." See American Institute of Certified Public Accounts ("AICPA"), Statement of Auditing Standards No. 69, ¶ 69.02 (1992), quoted in *Sanders v. Jackson*, 209 F.3d 998, 1001 n. 3 (7th Cir.2000).

the year 2000. Most significantly, Charter acknowledged for the first time that whereas it had previously reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount. (*Id.* at ¶ 15.)

Given the significance assigned operating cash flow, it was critically important whether a company expensed certain costs, or capitalized them over a period of time (in which case they were excluded from operating cash flow). (*Id.* at ¶ 43.) GAAP governs the accounting for such costs and the determination of whether they are expensed or capitalized.

Plaintiffs assert Andersen knew or recklessly ignored Charter's significant GAAP violations. They allege that while Charter's stated policy[4] conformed to GAAP, in actual

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4. Charter's *stated* accounting policy for expenses conformed to GAAP. The *stated* policy was:

> Costs capitalized as part of new *customer installations* include materials, subcontractors costs, internal direct labor costs, including service technicians and customer care representatives and internal overhead costs incurred to connect the customer to the plant from the time of installation scheduling through the time service is activated and functioning. We capitalize incremental and direct contract acquisition costs to the extent realizable from future revenues. The overhead rates established are based on a combination of internal company-wide overhead analysis and internal time and motion studies of specific activities. These studies are updated to adjust for changes in facts and circumstances. . . . The *costs of disconnecting and reconnecting* a customer are charged

(Cont'd)

practice, Charter consistently violated its own policy and GAAP by arbitrarily capitalizing material portions of certain labor related expenses in order to artificially enhance its operating cash flow results to be in line with Wall Street's expectations. This dovetailed with Charter's fraudulent inflation of its internal customer growth rate previously described. (*Id.* at ¶ 46.)

Plaintiffs assert the favorable, though fraudulent, results that Charter disseminated during the Class Period were intended to enable Charter to meet analysts' forecasts and thereby bolster the price of Charter stock. In turn, this enabled Charter to continue to use its stock as valuable currency on its acquisition spree, completing sixteen acquisitions in the years 1999 and 2000 alone. (*Id.* at ¶ 47.)

Plaintiffs assert senior Charter executives orchestrated a scheme to artificially inflate the number of Charter cable TV subscribers and misstate Charter's earnings by inflating Charter's operating cash flow. (*Id.* at ¶¶ 3- 9, 48-59, 62, 72-73, 83-94.) On the directives of corporate officers, Charter capitalized numerous labor costs that should have been expensed. (*Id.* at ¶ 62.) This widespread practice not only

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(Cont'd)

> to expense in the period incurred. *Expenditures for repairs and maintenance* are charged to operating expense as incurred, while equipment replacements and betterments, including the replacement of drops, are capitalized. (Emphasis in Amended Complaint.)

(*Id.* at ¶ 45.)

violated GAAP, Financial Accounting Standard 51,[5] ("FAS") but was inconsistent with Charter's own policy as set forth in its public filings, particularly with respect to repair and disconnection related expenses. (*Id.* at ¶ 63.) Charter also

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5. Financial Accounting Standard ("FAS") 51 governs the standards for accounting on specific issues related to the cable industry. Among other things, FAS 51 states:

> a. Labor costs associated with installing new services on the *first visit* to an address can be capitalized, and then depreciated over a period no longer than the period used to depreciate the cable television plant.
>
> b. A portion of associated "indirect" costs, that are associated with installation or upgrade labor costs may likewise be capitalized.
>
> c. The costs of subsequently disconnecting or reconnecting a subscriber (or an address) must be expensed. Thus, the second time a service is enabled at an address (even if it is a new subscriber), it must be expensed in the period incurred.
>
> d. "Subscriber related costs" and general administration expenses must be expensed in the period incurred. These costs include:
>
> > Cost of billing and collection, bad debts, mailings, repairs and maintenance of taps and connections, general and administrative systems costs such as salary of the system manager and office rent, programming costs for additional channels used in the marketing effort or costs related to revenues from per channel or per program service, and direct selling costs.

(*Id.* at ¶ 44.)

routinely capitalized significant portions of "reconnect" costs (costs to reconnect subscribers who had requested that their cable be disconnected or whose service had been terminated for failure to pay their bills). (*Id.* at ¶ 64(d).) As a result, plaintiffs assert Charter improperly capitalized costs totaling $93 million in 2001, and $52 million in 2000. (*Id.* at ¶ 64(e).)

Plaintiffs further assert Charter paid third-party contractors to conduct marketing campaigns and then improperly deferred the costs of those services rather than expensing them as incurred. (*Id.* at ¶ 64(h).) This practice was in direct violation of Statement of Position 93-7[6] ("SOP" 93-7), Reporting on Advertising Costs, which governs the accounting for advertising costs under GAAP. As a result, during 2001, $59 million in marketing campaign expenses were improperly deferred rather than expensed. (*Id.*)

---

6. SOP 93-7 states the following:

> The costs of advertising should be expensed either as incurred or the first time advertising takes place except for:
>
> a. Direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits (future benefits). Examples of the first time advertising takes place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.
>
> b. Expenditures for advertising costs that are made subsequent to recognizing revenues related to those costs.

Appendix D

Referring to the alleged sham arrangements with vendors Scientific-Atlanta and Motorola intended to artificially boost Charter's revenues and operating cash flow, the plaintiffs allege that indicative of the deliberately fraudulent nature of these transactions, Kent Kalkwarf "discussed the concept" with Arthur Andersen in August 2000, prior to any payments being exchanged. At the time Andersen stated that "Charter could not recognize the advertising payments as revenue because they appeared integrally related to the cost increases being paid by Charter." (*Id.* at ¶ 80.) Andersen advised Charter that it could recognize the advertising fees as revenues if the additional payments for the converter boxes and the advertising were (1) at fair market value; (2) unrelated to one another; and (3) negotiated at least one month apart.

In late August 2000, Kalkwarf advised Andersen that it would fulfill those conditions. In September 2000, Kalkwarf falsely told Andersen that the advertising and supply contracts with Scientific-Atlanta and Motorola had been negotiated by two separate departments at Charter, one month apart from each other. Plaintiffs allege that to lend further credibility to these claims, even though the set-top box price increases were not finalized with either vendor until late September 2000, the contracts were backdated to August 2000 on the instructions of Kalkwarf and David Barford, to give the false appearance that the set-top box price agreements were negotiated a month before the advertising contracts which were dated in late September. (*Id.* at ¶ 80.)

Despite being aware that Charter was seeking to generate additional revenue through a series of questionable transactions with these two vendors, Andersen accepted the

explanations provided by Kalkwarf and Barford, and failed to perform further audit checks, for example, requesting additional verification from the vendors as required under GAAS. (*Id.* at ¶ 81.)

In support of its motion, Andersen argues the Amended Complaint fails to allege facts sufficient to establish the required strong inference of scienter necessary to state a claim of securities fraud. Specifically, Andersen argues the Amended Complaint contains few allegations about Andersen and fails to establish Andersen acted with fraudulent intent. Andersen argues that the Amended Complaint largely addresses Charter's alleged conduct in calculating the number of its cable TV subscribers. Andersen notes that there is no allegation it approved or "certified" the subscriber count number in any way, nor could there be, because Andersen merely audited Charter's financial statements, which did not reference the subscriber count. Andersen argues the Amended Complaint fails to allege specific facts to support the conclusion that Andersen—at the time of the audits—knew of or recklessly disregarded GAAP and GAAS violations, or to suggest Andersen acted fraudulently or recklessly at the time it audited the financial statements. Andersen contends the allegation that it had "full access" to Charter's books, records and personnel, as well as plaintiffs' allegations as to GAAP and GAAS, are insufficient to establish the requisite strong inference of scienter under § 10(b).

Plaintiffs oppose the motion, asserting the Amended Complaint pleads numerous facts that, taken together, give rise to the requisite strong inference of scienter. They note that the magnitude of the fraud, involving improper

accounting for $487 million of Charter's revenues and expenses, and inflation of Charter's growth rate for operating cash flow by 100%, strongly suggests that Andersen was either a knowing or severely reckless participant in the fraud. They argue that Andersen disregarded numerous "red flags" which should have alerted it to Charter's fraud, including Charter's unusually high capitalization rate; its practice of including all new program launch fees paid by program providers at the initial date of a contract period, rather than amortizing these fees over the entire term of a contract; and its ignoring the series of sham transactions that Charter conducted with its two main digital converter-box providers in an effort to boost operating cash flow. Plaintiffs claim Andersen knew of Charter's deceptive purpose for these transactions, but did nothing to investigate them further as required by GAAS, noting that a Charter official discussed the propriety of booking revenues on the wash transactions with Andersen, who advised that Charter's plan would violate GAAP unless certain specific conditions were met. Despite being on notice of the true purpose of these transactions, as well as their presumptive illegitimacy, Andersen failed to make basic inquiries, such as requesting additional verification from the vendors when Charter represented that Andersen's conditions had been met.

Plaintiffs contend the magnitude of the GAAP violations, and the inference of scienter to be drawn therefrom, is confirmed by Charter's restatement after Andersen was replaced as auditor. Given the severity of the GAAP violations, Charter was forced to restate its 2000 and 2001 financials. For 2000, this resulted in reduced revenues of $108 million and increased expenses of $87 million. For

2001, this resulted in reduced revenues of $146 million and increased expenses by $146 million. Plaintiffs note that as a result, Charter's reported growth rate for 2001 was reduced by one half. The plaintiffs argue that these sums are not reasonable differences over interpretation and application of GAAP, but speak of a massive and concerted fraud that only the most callous auditor could fail to detect. (*Id.* at ¶¶ 43-44, 60-71, 75-82.)

The plaintiffs assert the combination of GAAP violations, red flags, and the financial restatement satisfy the scienter requirement. The Court agrees. Allegations of GAAP violations, alone, are insufficient to state a claim for securities fraud. *Navarre*, 299 F.3d at 745. However, GAAP violations coupled with evidence of corresponding fraudulent intent may state a securities fraud claim. *In re K-Tel Int'l, Inc.*, 300 F.3d 881, 894 (8th Cir.2002); *see also In re McKesson HBOC, Inc. Sec. Litig.*, 126 F.Supp.2d 1248, 1272 (N.D.Cal.2000) ("when significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter").

Plaintiffs allege Andersen knew or recklessly ignored Charter's significant GAAP violations, particularly noting Charter's operating cash flow rate growth rate, which was reported to be twice the actual operating cash flow growth rate. They allege the inflated results were achieved by accounting ploys such as the capitalization of labor costs that should have been expensed, as well as the recognition of non-existent revenues from sham transactions with Scientific-Atlanta and Motorola. They allege this practice not only violated GAAP and FAS 51, but was inconsistent

with Charter's own policy as set forth in its public filings, particularly the portion related to repair and disconnection related expenses. The plaintiffs allege Charter routinely but improperly capitalized significant portions of "reconnect costs," resulting in improperly capitalized costs totaling $93 million in 2001 and $52 million in 2000. Plaintiffs further argue Andersen knew or recklessly ignored Charter's significant GAAP violations, citing Charter's inflated operating cash flow as the linchpin of Charter's fraud. They note that whereas Charter reported that operating cash flow grew at 12-14% during the Class Period, its actual operating cash flow growth rate was only 6%.

Plaintiffs also allege Charter paid third-party contractors to conduct marketing campaigns and then improperly deferred the costs of those services rather than expensing them as incurred, in violation of SOP 93-7, Reporting on Advertising Costs, which governs the accounting for advertising costs under GAAP. As a result, the plaintiffs allege $59 million in marketing campaign expenses were improperly deferred rather then expensed in 2001.

Plaintiffs assert Andersen either knowingly or recklessly ignored several "red flags" in acquiescing to these violations. Courts have held allegations an auditor ignored "red flags" is probative of fraudulent intent or recklessness. *See e.g.*, *In re Health Mgmt. Inc. Sec. Litig.*, 970 F.Supp. 192, 203 (E.D.N.Y.1997); *In re Oxford Health Plans, Inc. Sec. Litig.*, 51 F.Supp.2d 290, 295-96 (S.D.N.Y.1999). This is a matter of degree, however, the probative value of allegations that an auditor ignored "red flags" is a function of the nature and number of such flags. *In re MicroStrategy*, 115 F.Supp.2d at

653-54. Thus, as one court stated, "while [defendant's] ignorance of warning signs in one sense demonstrate[s] that it was merely negligent, allegations that, with gross recklessness, [defendant] ignored multiple 'red flags' could reasonably support an inference that [defendant] acted with intent." *In re Leslie Fay Cos., Inc.*, 871 F.Supp. 686, 699 (S.D.N.Y.1995) (holding that an accountant's ignoring multiple "red flags" could reasonably support an inference that the accountant defendant acted with intent).

The first red flag plaintiffs note was Charter's "extraordinary" capitalization rate, which plaintiffs allege was by far the highest in the industry. They note that Charter's aggressive capitalization policy was one of the factors Merrill Lynch cited in deciding to downgrade its investment rating from "strong" to "neutral." The plaintiffs note that Merrill Lynch's ability to ascertain this indicator of Charter's troubles—without the benefit of the extensive access to Charter's books that Andersen enjoyed—is additional evidence of Andersen's recklessness. Plaintiffs maintain another red flag was Charter's practice of including all new program "launch fees" paid by program providers at the initial date of a contract period rather than amortizing them over the entire term of the contract.

Plaintiffs assert a third red flag was Charter's ignoring a series of sham transactions that Charter conducted with two vendors, Scientific-Atlanta and Motorola, in an attempt to boost operating cash flow. The plaintiffs allege that despite being on notice of the true purpose of these transactions, as well as their presumptive illegitimacy, Andersen failed to make basic inquiries, such as requesting additional

verification from vendors, when Charter represented that Andersen's conditions had been satisfied.

As previously stated, plaintiffs maintain Charter's significant financial restatement after Andersen was re-placed as auditor provides further inference of scienter. On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. Charter acknowledged for the first time that its "operating cash flow" had been inflated by 19.5% ($292 million) for the year 2001, and by 14.5% ($195 million) for the year 2000. Most significantly, Charter acknowledged for the first time that whereas it had previously reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount. (*Id.* at ¶ 15.) The plaintiffs allege these large figures suggest a massive and concerted fraud, not merely reasonable differences over interpretation and application of GAAP.

"The mere *fact* that there was a restatement or a violation of GAAP, by itself, cannot give rise to a strong inference of scienter; the *nature* of such a restatement or violation, however, may ultimately do so." *In re MicroStrategy*, 115 F.Supp.2d at 635. "Common sense and logic dictate that the greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly." *Id.* at 636. The Court agrees that the size of the restatement here is probative of a strong inference of scienter on the part of Andersen.

The plaintiffs finally argue that Andersen's knowledge of Charter's operations also supports a strong inference of

scienter. They note that throughout the relevant time period, Andersen had full access to Charter's books and revenues. The allegations that Andersen had knowledge of Charter's operations in and of itself is not probative of scienter. It does not necessarily follow that because Andersen had access to Charter's operations it was aware of the alleged fraud at Charter, but it is also true that the greater access Andersen's access to Charter operations, the greater the possibility of an inference of scienter. *See In re MicroStrategy*, 115 F.Supp.2d at 653.

This Court finds plaintiffs' allegations concerning Andersen's failure to detect Charter's purported fraud amount to an "egregious refusal to see the obvious, or to investigate the doubtful," thus creating a strong inference of scienter. *See Homestore*, 252 F.Supp.2d 1043. The Court finds these allegations, considered alone, would not be sufficient to raise a strong inference of scienter. However, the allegations do not exist in isolation. Taken together, the allegations provide important information on the context in which Andersen may have conducted its audits of Charter's financials, and therefore, this information is relevant to weighing the strength of any scienter inference.

Considering the Amended Complaint and drawing all inferences in favor of plaintiffs as is required in reviewing a motion to dismiss, the Court finds that the plaintiffs have established the heightened pleading requirements of the PSLRA. The Court concludes the Amended Complaint's allegations as to Andersen's GAAS violations, Charter's GAAP violations and subsequent financial restatements, Andersen's level of access to Charter and necessary

knowledge of its operations and most important contracts, and the existence of circumstances suggesting that Andersen was or should have been aware of Charter's accounting practices, taken in context and in light of the totality of the circumstances, raise a strong inference that Andersen acted with scienter. *Cf. Danis v. USN Communications, Inc.*, 73 F.Supp.2d 923 (N.D.Ill.1999) (plaintiffs satisfied pleading requirements under PSLRA where complaint alleged auditor/consultant violated GAAS, had sufficient contact with the company to become aware of fraudulent abuses, as well as pervasive and fundamental internal control problems at company; court noted auditor was hired to consult, and did not simply allege auditor had access to information); *In re Cendant Corp. Sec. Litig.*, 60 F.Supp.2d 354, 372-73 (D.N.J.1999) (denied accounting firm's motion to dismiss where plaintiffs alleged operating income was overstated, earnings per share were overstated, audits were not performed in accordance with GAAS, and quarterly financial statements were materially false and misleading). Accordingly, Andersen's motion to dismiss should be denied.

D. Settling Parties' Joint Motion for a Protective Order

Finally, also before the Court is a joint motion for a protective order filed by Charter and plaintiffs. As previously stated, plaintiffs, Charter, and the individual defendants state that they have reached a tentative settlement. They also state that they have entered into a Memorandum of Understanding ("MOU"). The MOU contemplates Charter's voluntary commitment to make a limited number of mutually agreed-upon witnesses under its control available for interviews or meetings with plaintiffs, and to provide plaintiffs with requested documents as necessary to facilitate due diligence

concerning the fairness of the proposed settlement. The Proposed Protective Order ("PPO") applies only to these voluntary disclosures made by Charter. The PPO further provides that, after the plaintiff's due diligence is completed, plaintiffs "shall retain the right to utilize the documents produced [by Charter] in accordance with this Order solely to litigate its existing claims against the non-settling defendants in this action." ¶ 18.

Anderson, the remaining defendant which is not a party to the tentative settlement, objects to provisions of the PPO.[7] Andersen argues that due to the pendency of its motion to dismiss, a stay of discovery already exists pursuant to the Reform Act, and thus, plaintiffs are not permitted any discovery relevant to the claims against it unless and until plaintiffs demonstrate they have sufficiently stated a claim under the Reform Act. Thus, Andersen seeks to prohibit the use of documents received by plaintiffs that would interfere with or undercut the protections afforded to it under the Reform Act. Andersen argues plaintiffs' claims against it be based on the allegations in the Amended Complaint and that any documents obtained by plaintiffs not be used for purposes of responding to the pending motions to dismiss and for drafting a second amended complaint in response to a ruling sustaining the motions to dismiss.

Andersen further argues that the Federal Rules do not authorize its exclusion from discovery conducted under the auspices of the Court. Andersen argues alternatively that even

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7. Scientific-Atlanta and Motorola also opposed the PPO. Their arguments are moot in light of the Court's ruling on their motions to dismiss.

if the Federal Rules do not obligate the Court to reject their PPO, fundamental fairness and efficiency require that they be given simultaneous access to the information Charter provides. Andersen also seeks the opportunity to monitor the ongoing discovery between the settling parties, including being provided access to whatever documents are made available to plaintiffs, as well as notice and an opportunity to attend the interviews at its expense.

Charter responds that Andersen has failed to demonstrate it has a right to participate in this informal exchange of information. As an accommodation, Charter states it will provide Andersen with access to the documents given, but will not permit it to attend the informal interviews contemplated by the MOU. Charter asserts that the contemplated interviews are part of a voluntary exchange of information in furtherance of settlement, not depositions compelled by the Federal Rules or court process, and thus are outside the ambit of formal discovery governed by the Federal Rules and the Reform Act. Charter further maintains Andersen will suffer no prejudice as a result of being denied access to the interviews given that the interviews constitute inadmissible out of court statements that cannot be used by any other party not in attendance.

The purpose of the Reform Act was "to restrict abuses in securities class-action litigation, including: (1) the practice of filing lawsuits against issuers of securities in response to any significant change in stock price, regardless of defendants' culpability; (2) the targeting of "deep pocket" defendants; (3) the abuse of the discovery process to coerce settlement; and (4) manipulation of clients by class action

attorneys." *SG Cowed Sec. Corp. v. United States District Court for the Northern District of California*, 189 F.3d 909, 911 (9th Cir.1999) (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530-31 (3d Cir.1999)). The Reform Act "mandated a stay of discovery during the pendency of a summary judgment or dismissal motion." *Id.* Under the Reform Act, "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C. § 78u-4(b)(3)(B). The stay provision was "intended to prevent unnecessary imposition of discovery costs on defendants." *SG Cowed*, 189 F.3d at 911 (citing H.R. Conf. Rep. No. 104-369, 104th Cong. 1st Sess. at 32 (1995), reprinted in 1995 U.S.C.C.A.N. Sess. 731).

The Court concludes Andersen has been afforded the protections of the Reform Act's stay provision. The Court further concludes Andersen's concern regarding the protections of stay provision is moot based on the Court's ruling that plaintiffs have sufficiently stated a claim under the Reform Act.

The Court further concludes Andersen has not demonstrated it has a right to participate in the exchange of information between the settling parties. The contemplated interviews or informal discovery are with individuals under Charter's control, not Andersen representatives, and are part of a voluntary exchange of information in furtherance of settlement, not depositions compelled by the Federal Rules or court process.

Appendix D

The parties have not provided any case authority that is factually analogous to the situation at hand, nor is the Court aware of any. In *JDS Uniphase Corp. Sec. Litig.*, 238 F.Supp2d 1127 (N.D.Cal.2002), the plaintiffs sought a court order allowing defendant's former employees to speak voluntarily to plaintiffs' lead counsel about certain topics without fear of breaching their former employer's confidentiality agreements. No motion to dismiss was pending. The court held that it was not discovery under the Federal Rules, because the plaintiffs were not using court process to require these third parties to provide information about the lawsuit, but were merely seeking an order that would allow former employees to speak voluntarily if they wished to do so. The court held that unlike discovery and initial disclosures, the interviews were not compelled by the Federal Rules. Neither the former employees nor the defendants were required to participate in these interviews in any way. *Id.* at 1134. The court reiterated that "the Reform Act was not intended to provide defendants with immunity from suit, but, rather, was intended to protect defendants from the burdens of defending against frivolous litigation." *Id.* at 1134. *Cf. In re Tyco Int'l Ltd. Sec. Litig.*, 2001 U.S. Dist. Lexis 819 (D.N.H.2001) (district court declined to prohibit voluntary discussions between plaintiffs and third party witnesses, stating "[n]either logic, tradition, the constitution nor the PSLRA prohibit interviewing prospective witnesses"); *Maley v. Del Global Techs. Corp.*, 186 F.Supp.2d 358, 363-64 (S.D.N.Y.2002) (securities fraud class action submitted proposed settlement for approval to district court; settlement was fair despite lack of formal discovery based in part on "confirmatory" discovery, including production of documents, interviews with senior officials, and inspection

of company's facilities); *Connecticut Gen. Life Ins. Co. v. Connecticut Gen. Life Ins. Co.*, M.D.L. 1156, No. CV 95-3566, 1997 WL 910387 (C.D.Cal. Feb.13, 1997) (parties sought certification of the settlement class and final judgment approving the settlement; permitting informal confirmatory discovery to verify certain facts provided during settlement negotiations.)

The Court believes Andersen will suffer no prejudice by not being permitted to attend the informal interviews contemplated by the MOU in light of the fact that it will be provided access to the documents that will be provided to plaintiffs. Therefore, the Court will grant the joint motion for a protective order and will enter the PPO as submitted by the parties to the tentative settlement. Charter and plaintiffs will provide Andersen access to the documents provided by Charter as long as Andersen agrees to be bound to the terms of the Protective Order.

III. CONCLUSION

For the above reasons, the Court concludes that plaintiffs' claims against defendants Scientific-Atlanta and Motorola are barred by *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), and accordingly, the Court will grant their motions to dismiss the Amended Complaint. The Court also concludes plaintiffs have satisfied their pleading burden under the PSLRA to maintain their claims against Arthur Andersen. Therefore, the Court will deny Andersen's motion to dismiss. The Court will grant the joint motion for a protective order and will enter the PPO as submitted by the parties to the tentative settlement. Accordingly,

Appendix D

IT IS HEREBY ORDERED that the stay in this action is lifted.

IT IS FURTHER ORDERED that Scientific-Atlanta, Inc.'s motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is **GRANTED**. (Doc. 133)

IT IS FURTHER ORDERED that Motorola, Inc.'s motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is **GRANTED**. (Doc. 150)

IT IS FURTHER ORDERED that Motorola, Inc.'s motion for a hearing on its motion to dismiss is **DENIED**. (Doc. 212)

IT IS FURTHER ORDERED that Arthur Andersen's motion to dismiss Count IV of the amended consolidated class action complaint is **DENIED**. (Doc. 138.)

IT IS FURTHER ORDERED that the Joint Motion for a Protective Order is **GRANTED**. (Doc. 242.)

IT IS FURTHER ORDERED that Arthur Andersen's Motion for Leave to File a Surreply Regarding the Joint Motion for a Protective Order is **DENIED**. (Doc. 250.)

Appendix D

IT IS FURTHER ORDERED that Scientific-Atlanta's Motion for leave to Submit a Supplemental Memorandum Regarding the Joint Motion for a Protective Order is **DENIED**. (Doc. 251.)

s/ Charles A. Shaw
CHARLES A. SHAW
UNITED STATES DISTRICT JUDGE

Dated this 12th day of October, 2004.

(3)

No. 06-43

Supreme Court, U.S.
FILED
OCT 19 2006
OFFICE OF THE CLERK

In The Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

RESPONDENT SCIENTIFIC-ATLANTA, INC.'S OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Do *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), and Section 10(b) contemplate private claims against secondary actors who make no misstatements or omissions to investors (and who owe no duty), but who are nevertheless alleged to have provided "behind-the-scenes" aid or assistance to the party who actually made the misstatements and omissions to investors?

CORPORATE DISCLOSURE STATEMENT

On February 27, 2006, Scientific-Atlanta, Inc. became a wholly owned subsidiary of Cisco Systems, Inc. Since that date, Scientific-Atlanta, Inc. has had no outstanding stock. No publicly held company owns 10% or more of the stock of Cisco Systems, Inc.

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INTRODUCTION

This Court should refuse to grant the requested writ of certiorari. The Eighth Circuit's ruling is squarely grounded in this Court's precedent defining the scope of primary liability under the federal securities laws. (*See infra* at 4-14.) Applying this precedent, the circuit court held that Petitioner's claims were foreclosed as a matter of law. The Petition fails to identify any compelling reason to revisit this decision.

All parties agree that *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994), precludes a plaintiff from bringing a private cause of action for aiding and abetting another party's purported securities law violations. *Central Bank* also held that primary liability exists only where the person or entity accused "employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies . . . , assuming *all* of the requirements for primary liability . . . are met." *Id.* (emphasis in original); *see also id.* at 177.[1] Petitioner's theory of liability violates *Central Bank*.

First, Petitioner seeks to pursue classic aiding and abetting claims under the guise of the new label of

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[1] Petitioner inaccurately suggests that this holding is "dictum." (*See* Pet. at 15.) This rule of law is, however, repeated twice in the opinion. *See Central Bank*, 511 U.S. at 177, 191. Moreover, each time it is discussed, it is clear from the context that the statement is not "dictum," but a repetition of long-established principles. *See, e.g., id.* at 177 ("*As in earlier cases* considering conduct prohibited by § 10(b), *we again conclude* that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.") (emphasis added).

"scheme liability." Second, Petitioner fails to allege either a "manipulative device" or "a material misstatement (or omission)" as to Scientific-Atlanta, Inc. ("S-A") as required under Section 10(b). (*See infra* at 5-12.) Third, because its claims are aiding and abetting, Petitioner has not and cannot satisfy all of the requirements for primary liability under Section 10(b). (*See infra* at 13-20.) There was, therefore, no error in the lower court's decision to dismiss these claims.

STATEMENT OF THE CASE

Petitioner is a Charter investor who sued Charter and its former officers and directors for primary violations of the federal securities laws. Months later, as an afterthought, Petitioner added to the case S-A – a separate public company that did business with Charter – under an aiding and abetting theory. (*See* Amended Consolidated Class Action Complaint dated August 4, 2003, attached hereto as Appendix ("Resp. App.") at 2, 10.)[2] Petitioner alleged that Charter manipulated its accounting of business transactions with its equipment suppliers: S-A and Motorola, Inc. (*See id.* at 3-4.) Based on this allegation, Petitioner purported to assert a cause of action under Section 10(b) of the Securities Exchange Act of 1934 (the "Act"), 15 U.S.C. § 78j(b), and SEC Rule 10b-5(a)-(c), 17 C.F.R. § 240.10b-5, for aiding and abetting the fraud on

[2] After dismissal, Petitioner sought permission to file a second amended complaint, which was denied as futile by the lower court. *See In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987, 993 (8th Cir. 2006), attached to the Petition for Certiorari as Appendix A ("Pet. App.") at 11a.

Charter's shareholders, which had allegedly been committed by Charter. (*See id.* at 79-80.)

According to the Complaint, S-A allegedly entered into a marketing support agreement with Charter at Charter's request whereby Charter would pay additional sums for each set-top box purchased from S-A and S-A would return this money to Charter in the form of marketing support for advertising. (*See id.* at 3-4, 31-34.) Along with other disclosures of accounting errors, Charter ultimately announced that it had failed to properly account for this transaction with S-A. (*See id.* at 63-70.) The transaction, if properly accounted for, would have resulted in no net economic benefit to either party. (*See id.* at 32-34.)

The Complaint was based *exclusively* on public statements attributed *only to Charter* regarding *Charter's* financial results. (*See, e.g., id.* at 38-63.) The Complaint did not allege that S-A drafted any of the purported misleading statements, nor was it alleged to have had any involvement in the contents of Charter's public statements, control over their circulation, or the ability or duty to independently verify their accuracy. (*See* Pet. App. at 9a-10a.). Petitioner did not dispute that S-A's accounting treatment for this agreement was proper, nor did Petitioner dispute that it was possible for Charter to have accounted for the agreement properly on its books. (*See* Resp. App. at 33-34.) Moreover, the Complaint did not allege that S-A, a third-party vendor, had any involvement in or control over the internal accounting decisions made by Charter and its outside auditors. The Complaint also did not allege any misstatement or omission by S-A to Charter's shareholders. (*See* Pet. App. at 10a ("[S-A] did not issue any misstatement relied upon by the investing public, nor w[as] [it] under a duty to Charter investors and

analysts to disclose information. . . .").) Indeed, Petitioner abandoned the claim it originally had against S-A for Charter's misstatements under Rule 10b-5(b). (*See* Resp. App. at 80.)

Instead, Petitioner now stresses that its claims against S-A – a supposed scheme "to commit a misstatement" – are based on "conduct," which it argues is covered by subparts (a) and (c) of Rule 10b-5. (*See id.* at 3-4, 80.) Petitioner did not allege, however, that it relied on S-A's alleged "scheme" in making its investment decision. Petitioner alleged only that it relied on Charter's alleged misstatements and omissions in making its investment decision. (*See, e.g., id.* at 79-80.)

REASONS FOR DENYING THE WRIT

I. THE CIRCUIT COURT CORRECTLY FOLLOWED PRIOR DECISIONS ON THE SCOPE OF PRIMARY LIABILITY UNDER SECTION 10(B)

As a threshold matter, Petitioner's request for a writ of certiorari propounds an inaccurate reading of the court of appeals' decision. The Petition incorrectly suggests that the Eighth Circuit held that Section 10(b) is limited "only to misleading statements and omissions." (Pet. at 12.) This is incorrect. The circuit court specifically acknowledged that, in addition to misstatements or omissions, certain types of manipulative trading conduct can also be the basis of Section 10(b) claims. (*See* Pet. App. at 5a.) There are no such allegations against S-A. There are also no allegations of any misstatements or omissions by S-A. Indeed, as the lower court held, the conduct of which S-A now stands accused is not prohibited by the text of Section

10(b). Dismissal was, therefore, appropriate. *See Central Bank*, 511 U.S. at 173.

A. "Deceptive Conduct" Involves Either A Misstatement Or A Failure To Disclose By One Who Has A Duty To Speak.

As the Eighth Circuit recognized, a private plaintiff "'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).'" (Pet. App. at 8a (quoting *Central Bank*, 511 U.S. at 173).) Section 10(b) makes it unlawful "'[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance. . . .'" (Pet. App. at 4a (quoting 15 U.S.C. § 78j(b)).) Therefore, to state a claim for primary liability under Section 10(b), Petitioner must show that S-A's alleged conduct constitutes a "manipulative or deceptive device or contrivance" within the meaning of Section 10(b). The Eighth Circuit recognized that this inquiry applies with equal force to any subpart of Rule 10b-5 on which a plaintiff purports to bring its claims. (*See* Pet. App. at 8a.) Section 10(b) expressly requires either deceptive or manipulative conduct, and Rule 10b-5 can be no broader in application than the governing statute that authorized that rule. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) ("[D]espite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b).").

The Eighth Circuit looked to this Court's prior opinions, which have held that "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." (Pet. App. at 8a.) The Eighth Circuit

correctly relied on the following three decisions, which evidence this rule of law: *Affiliated Ute Citizens of the State of Utah v. United States*, 406 U.S. 128 (1972); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); and *United States v. O'Hagan*, 521 U.S. 642 (1997).

All of these cases support the circuit court's analysis that where, as here, there is no duty to disclose and no corresponding misrepresentation or omission, there is no deceptive device or contrivance on which a Section 10(b) claim may be based. In each case, the issue of whether a defendant's conduct was "deceptive" turned on the existence (or lack thereof) of a duty to speak and a misstatement or omission. These cases do not support Petitioner's contention that liability for "deceptive" conduct may exist absent an alleged misstatement or omission.

Affiliated Ute. This Court found a cause of action in *Affiliated Ute* because the defendants made material omissions in the face of a duty of disclosure owed to the injured shareholders. *Affiliated Ute*, 406 U.S. at 153 (describing the case as "involving primarily a failure to disclose"). While observing that only subpart (b) of Rule 10b-5 speaks specifically in terms of affirmative misstatements, this Court found that claims were stated under subparts (a) and (c) and were "deceptive" within the meaning of the Act because defendants withheld information where they owed a duty of disclosure:

> These defendants' activities . . . disclose, within the very language of one or the other of those subparagraphs, a 'course of business' or a 'device, scheme or artifice' that operated as fraud upon the Indian sellers. *This is so because the defendants devised a plan and induced the mixed-blood holders of UDC stock to dispose of their*

> *shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell. . . .* It is no answer to urge that . . . these defendants may have made no positive representation or recommendation. The defendants may not stand mute. . . . The sellers had a right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in [the non-Indian] market.

Id. at 153 (emphasis added and citations omitted).

Santa Fe. In *Santa Fe,* the majority shareholders of a company utilized a "short-form merger" transaction to eliminate the interests of certain minority shareholders. *See* 430 U.S. at 465-66. The minority shareholders opposed the sale and claimed that the majority owners violated Rule 10b-5(a) and (c) by paying an inadequate (low) price for their shares and by obtaining a fraudulent appraisal of their stock to justify the lower price. *Id.* at 467-68.

This Court accepted the finding of the district court that there were no omissions or misstatements in the information about the merger sent to the minority shareholders. *Id.* at 474. It was the absence of omissions or misstatements that set this case apart from other decisions of the Court where liability was found to include "some element of deception." *Id.* at 475.[3] For this reason, the Court concluded that its prior cases "do not support the proposition . . . that a breach of fiduciary duty by

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[3] The Court discussed *Affiliated Ute* and *Superintendent of Insurance,* both of which, as discussed above and *infra,* involved misstatements or omissions that gave rise to the necessary element of deception. *Santa Fe,* 430 U.S. at 475 n.15.

majority stockholders, without any deception, misrepresentation, or nondisclosure, violated the statute and the Rule." *Id.* at 476.

Petitioner makes much of the fact that the Court listed these items in the disjunctive (*see* Pet. at 12), but it overlooks the holding of the case. Without a misrepresentation or omission, the transaction at issue (which the minority shareholders argued was without a "justifiable business purpose") could not form the basis of a securities fraud claim. *Santa Fe*, 430 U.S. at 476.[4] In other words, the Court explicitly refused to expand the scope of liability where to do so would not serve the "fundamental purpose" of the Act, which is to insure full and fair disclosure for buyers and sellers of stock. *Id.* at 477-78. Because there had been full disclosure on the merger terms by one with a duty to disclose, no "deceptive" conduct within the meaning of the Act had been alleged and no claim could lie. *Id.* at 474-76.

O'Hagan. This Court also made clear in *O'Hagan* that "deceptive nondisclosure is essential to the § 10(b) liability at issue" in cases involving trading on non-public information. 521 U.S. at 660. Classic insider trading "qualifies as a 'deceptive device' under § 10(b) . . . because 'a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.'" *Id.* at 652. "That relationship . . . 'gives rise to a duty to disclose [or to abstain from

[4] The Court's finding that defendant's conduct also was not "manipulative" within the meaning of Section 10(b) is discussed *infra* at 11-12.

trading] because of the necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders.'" *Id.*

Similarly, the "misappropriation theory" adopted in *O'Hagan* – where an outsider to a company trades on nonpublic information – likewise turns on the existence of a duty and a non-disclosure. *See id.* at 652-53. "[T]he misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information." *Id.* The misappropriators similarly "deal in deception" through nondisclosure, pursuant to which liability under Section 10(b) may attach. *See id.* at 653.

***Superintendent of Insurance* and *Zandford*.** *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), and *SEC v. Zandford*, 535 U.S. 813 (2002), do not assist Petitioner. Those cases involve deceptive conduct in the form of either misstatements or omissions. In *Superintendent of Insurance*, the Court found that a claim under Section 10(b) was stated where a company's board of directors was deceived into authorizing the sale of its stock "by the *misrepresentation* that the proceeds would be exchanged for a certificate of deposit of equal value." 404 U.S. at 167 n.1 (emphasis added).

Similarly, in *Zandford*, a broker had been given a power of attorney that allowed him to execute stock transactions for his clients. 535 U.S. at 817. The broker represented to the clients that he would "conservatively invest" their money and would pursue investment objectives for the "safety of principal and income." *Id.* The broker, however, sold the securities in the account and personally pocketed the proceeds. *Id.*

A cause of action existed under Section 10(b) because "each sale [of stock] was made to further [the broker's] fraudulent scheme [and] each was deceptive because it was neither authorized by, nor disclosed to, the [clients]." *Id.* at 820-21. The clients "were injured as investors through [the broker]'s deceptions" and "were duped into believing [he] would 'conservatively invest' their assets in the stock market and that any transactions made on their behalf would be for their benefit for the 'safety of principal and income.'" *Id.* at 822. The broker was in a position of trust and acted as a fiduciary to his clients. Accordingly, he owed them a duty of disclosure and deceived them by failing to disclose his true intention to use the stock sales proceeds for his personal benefit. *Id.* at 822-23.[5]

As the above discussion indicates, the Eighth Circuit correctly followed this Court's directives as to the type of activity that qualifies as a "deceptive device or contrivance" under the Act.

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[5] Petitioner focuses on the following statement in *Zandford*: "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." (Pet. at 17 (quoting *Zandford*, 535 U.S. at 820).) However, this Court was referring to the lower court's reluctance to find a claim where "[i]t is not even alleged that [the broker] misled [his clients] about the relative merits or value of particular securities." *SEC v. Zandford*, 238 F.3d 559, 564 (4th Cir. 2001). Section 10(b) liability, however, extends to both affirmative misrepresentations as discussed by the lower court and omissions where a duty to speak exists. Indeed, the *Zandford* Court stated that the distinction between affirmative misstatements and omissions is "illusory" where the context is a broker who has a fiduciary duty to his or her clients. 535 U.S. at 823. *Zandford*, thus, does not support the view that "deception" under the Act extends beyond misrepresentations or omissions. Rather, *Zandford* reflects the omissions variety of deceptive conduct previously recognized by this Court.

B. "Manipulative" Conduct Refers To Illegal Securities Trading Practices And Not To Business Transactions.

An alternative basis for a Section 10(b) claim exists if the conduct is "manipulative" under the Act. The Eighth Circuit recognized that this term has been given "the limited contextual meaning ascribed in *Santa Fe*." (Pet. App. at 8a.) "Manipulative" is considered to be "'a term of art' and refers to illegal trading practices such as 'wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.'" (Pet. App. at 5a (quoting *Santa Fe*, 430 U.S. at 476).) In *Santa Fe*, this Court declined to expand the term beyond its commonly accepted usage. Thus, the request to do so here does not justify granting the Petition.

In *Santa Fe*, this Court held that the term "manipulative" as used in Section 10(b) did not extend to the defendant's actions in executing a short-form merger or in obtaining an allegedly fraudulent appraisal to justify a lower buy out price. 430 U.S. at 476-77. The Court found that this business conduct was not the type of manipulative trading activity the securities laws were designed to reach:

> Section 10(b)'s general prohibition of practices deemed by the SEC to be "manipulative" in this technical sense of artificially affecting market activity in order to mislead investors is fully consistent with the fundamental purpose of the 1934 Act "to substitute a philosophy of full disclosure for the philosophy of caveat emptor. . . ." Indeed, nondisclosure is usually essential to the success of a manipulative scheme. No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities

> prices. But we do not think it would have chosen this "term of art" if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as this. . . .

Id. (citations omitted).

Ernst & Ernst is also instructive and was cited by the Eighth Circuit. *Ernst* held that the term "manipulative" "is and was virtually a term of art when used in connection with securities markets" referring to "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." 425 U.S. at 199. Petitioner cites to other definitions discussed in *Ernst*, but tellingly avoids the Court's discussion of the word "manipulate." (*See* Pet. at 11-12.) The *Ernst* Court noted that "manipulate" when used in reference to "Exchanges" means "[t]o force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig." *Id.* at 199, n.21.[6] This is consistent with the Eighth Circuit's opinion and *Santa Fe*. There was no error in the circuit court's handling of this issue or in the application of precedent as demonstrated above.

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[6] It is important to note that Petitioner cites to portions of the *Ernst* decision that do not reflect the Court's holding, but instead summarize the position of the Securities and Exchange Commission that was rejected by the Court. (*See* Pet. at 12 (citing *Ernst*, 425 U.S. at 212).)

C. Because S-A's Conduct Was Neither Manipulative Nor Deceptive Under The Act, Petitioner's Claims Are At Most Aiding And Abetting.

Petitioner suggests that the court of appeals erred in its application of *Central Bank* – claiming that *Central Bank* did not purport to address what constitutes a claim for primary liability under Section 10(b). (*See* Pet. at 14.) The circuit court's decision that no claim was possible, however, was based on both *Central Bank*'s prohibition against aiding and abetting claims and this Court's prior interpretation of what constitutes deceptive or manipulative devices for purposes of primary liability. (*See* Pet. App. at 8a-10a.) If the conduct of a defendant falls short of this Court's definition of primary liability, the conduct is at most non-actionable aiding and abetting. The court of appeals correctly concluded that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." (*Id.* at 9a.)

Here, it is undisputed that S-A made no statements to Charter shareholders and could not be responsible for any actionable omissions to them, given that it owed no duty to speak to Charter's investors (a fact which Petitioner does not dispute). (*See id.* 9a-10a.) It is similarly without dispute that S-A did not engage in any manipulative trading practices regarding Charter stock that could have affected its market or its prices. (*See id.*) Thus, Petitioner has failed to plead a cognizable claim for primary liability.

Petitioner's theory is based solely on S-A's participation in the marketing support transaction – the only

conduct of S-A alleged in the Complaint. The Complaint, however, concedes that this type of agreement could have been accounted for properly by Charter – as S-A did on its books. Further, Petitioner alleges no efforts by S-A to misrepresent this transaction to Charter's shareholders – it alleges only that *Charter* misrepresented it.[7] Petitioner does not claim that any Charter shareholders were even aware of the transaction. As this Court held in *Central Bank*, "[w]e cannot amend [Section 10(b)] to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." 511 U.S. at 177-78. Aiding and abetting claims are designed to "reach[] persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* at 176. Because the only conduct alleged against S-A – an agreement for marketing support – is not proscribed by the statute, the claim asserted is one of aiding and abetting the allegedly prohibited conduct of other parties, which is barred by *Central Bank*. *Id.*[8]

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[7] Petitioner makes additional allegations regarding certain documentation on the marketing support transaction, attempting to create the appearance of a "deceptive" act. (*See* Pet. at 21.) But Petitioner never explains how this conduct supposedly reached or affected Charter shareholders. Petitioner does not allege that any shareholders ever saw these documents or that their contents were disclosed publicly. Moreover, as discussed *infra*, these documents had no relation to the purchase or sale of any Charter securities, and Charter investors did not purport to rely on these documents for purposes of making their investment decisions.

[8] Petitioner's speculation that S-A "knew" Charter intended to use the marketing support agreement to artificially inflate its reported financial results does not save its claims. These allegations confuse "the distinction drawn in *Central Bank* between primary violators and aiders/abettors based on conduct with the separate issue of scienter." *SEC v. U.S. Environmental, Inc.*, 155 F.3d 107, 111 (2d Cir. 1998).

(Continued on following page)

II. PETITIONER'S THEORY OF "SCHEME" LIABILITY FAILS TO SATISFY THE REQUIREMENTS FOR PRIMARY LIABILITY AND DOES NOT SUPPORT THE UNDERLYING PURPOSE OF THE ACT

There can be no claim for primary liability under Section 10(b) unless all of the necessary elements have been met as to each defendant. *Central Bank*, 511 U.S. at 191. However, Petitioner has not pled, *inter alia*, (1) any deceptive or manipulative act committed by S-A, as discussed above, (2) that was in connection with the purchase or sale of Charter stock, and (3) on which Petitioner relied. Petitioner's failure to plead all the well-established and necessary elements of a claim under Section 10(b) provides another basis for denying certiorari.

A. S-A's Alleged Conduct Was Not "In Connection With The Purchase Or Sale Of Any [Charter] Security."

Central Bank observed that Section 10(b) "imposes private civil liability on those who commit a manipulative or deceptive act *in connection with the purchase or sale of securities*." 511 U.S. at 166 (emphasis added); *see also* 15 U.S.C. § 78j. S-A, however, neither bought nor sold Charter securities and is not alleged to have had any connection with the transactions by which Petitioner or other putative class members became investors in Charter. The

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Whether the defendant "was a primary violator rather than an aider and abettor turns on the nature of his acts, not on his state of mind when he performed them." *Id.* Accordingly, conclusory allegations of a shared intent by S-A and Charter to mislead Charter's investors cannot create a cause of action against S-A under the Act.

marketing support agreement involved the sale of digital set-top boxes, not the sale of Charter stock.

A commercial transaction unconnected to the purchase or sale of a security cannot be deemed to fall within Section 10(b) simply because the party standing on the other side of the transaction was a public company whose stock was purchased and sold by investors. Such a result would extend the scope of liability far beyond the text of the statute. Section 10(b) should not be interpreted so broadly as to convert every allegation of common-law fraud that happens to involve securities into a putative Section 10(b) claim. *See, e.g.*, *Zandford*, 535 U.S. at 820; *see also Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."); *Chiarella v. United States*, 445 U.S. 222, 232 (1980) ("[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b).").

All the decisions of this Court on which Petitioner purports to rely demonstrate the importance of the "in connection with" requirement. In each of these cases, the defendant had personally engaged in conduct directly "in connection with the purchase or sale of a security," unlike here. *See, e.g.*, *Zandford*, 535 U.S. at 824-25 (broker *sold customer's securities* without permission and without disclosing intent to misappropriate proceeds); *O'Hagan*, 521 U.S. at 659 (holding that secretly using misappropriated confidential information *for trading purposes* violated Section 10(b)); *Affiliated Ute*, 406 U.S. at 151-53 (finding that defendants could be liable under Rule 10b-5(a) and (c) because they *executed plaintiffs' stock sales* on which they stood to personally profit and were also *purchasers of the same stock* on their own behalf and on behalf of other

accounts they solicited, set up, and on which they received commissions); *Superintendent of Ins.*, 404 U.S. at 9-10 (misleading investor *into selling treasury bonds* on erroneous belief that it would receive proceeds from the sale). The marketing support agreement between S-A and Charter is not, and has not been alleged to be, "in connection with the purchase or sale" of Charter stock. This missing element is an independent basis for the correctness of the circuit court decision and denial of the Petition.

B. Petitioner Cannot Satisfy The Mandatory Requirement Of Reliance.

Petitioner's theory of scheme liability also fails because it cannot plead reliance or transaction causation. The inability to demonstrate reliance is one of the reasons why aiding and abetting claims cannot be allowed. *Central Bank*, 511 U.S. at 180. Under *Central Bank*, primary liability under Section 10(b) requires "a manipulative device or . . . a material misstatement (or omission) *on which a purchaser or seller of securities relies. . . .*" 511 U.S. at 191 (emphasis added).

Petitioner has not pled that it relied on anything S-A said or did. In fact, Petitioner shareholder does not dispute that it relied solely on the public statements of Charter and the purported effect of those statements on Charter's stock price. This is fatal to its claims. Under *Central Bank*, there is no exception to the requirement of pleading reliance simply because a plaintiff chooses to sue multiple defendants whom it claims participated together in an alleged "scheme." Petitioner must plead individual reliance or be able to avail itself of a judicially recognized presumption of reliance, such as the "fraud-on-the-market"

theory from *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The Petition makes reference to neither.

In any event, under the fraud-on-the-market theory, only *publicly available information and misleading statements* released to the market by Charter could have influenced the price of Charter's securities. *See id.* at 247 ("Because most publicly available information is reflected in market price, an investor's reliance on *any public material misrepresentations*, therefore, may be presumed for purposes of a Rule 10b-5 action.") (emphasis added). There were no statements issued to the market by S-A regarding the subject transaction or Charter. Thus, the essential element of reliance does not and cannot exist here, which requires dismissal under *Central Bank*. *See* 511 U.S. at 180 ("Allowing plaintiffs to circumvent the reliance requirement [through aiding and abetting claims] would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.").[9]

[9] Petitioner's theory of scheme liability also fails because it cannot allege sufficient facts to show loss causation, another mandatory requirement of Section 10(b). *See generally Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). Loss causation "cannot be found if an intervening cause was responsible for the plaintiff's economic loss." *Unterberg Harris Private Equity Partners, L.P. v. Xerox Corp.*, 995 F. Supp. 437, 441 (S.D.N.Y. 1998). Petitioner alleges no facts to show that the marketing support transaction itself (and not Charter's intervening alleged improper accounting) caused any of the purported inflation of the price of Charter stock. Had Charter accounted for the transaction properly, there would have been no purported artificial inflation, and Petitioner concedes that such transactions could be accounted for properly.

C. Expanding The Scope of Liability As Petitioner Requests Would Not Fulfill The Purpose Of The Act.

As prior precedent from this Court demonstrates, the goal of the Act is to promote disclosure. *See, e.g., Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (noting that "[o]ne of [the Act's] central purposes is to protect investors through the requirement of full disclosure by issuers of securities, ..."); *see also Affiliated Ute*, 406 U.S. at 151 (the Act "embrace[s] a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor. . . .'"). "[A] private cause of action under the antifraud provisions of the . . . Act should not be implied where it is 'unnecessary to ensure the fulfillment of Congress's purposes' in adopting that Act." *Santa Fe*, 430 U.S. at 477.

The recognition of a cause of action here would not promote this essential goal of disclosure. The party which Petitioner contends should have disclosed the "true" facts is Charter. The proposed defendant S-A is a separate entity altogether which owed the Charter shareholders no disclosure obligations. S-A is also not alleged to have had the ability to police the public statements of Charter or to have been involved in their preparation or circulation.

Moreover, to recognize the cause of action sought by Petitioner would add uncertainty to this area of the law. As this Court found in *Central Bank*, "'[s]uch a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5' is not a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions.'" 511 U.S. at 188 (citations omitted). Concerns over expanding the scope of potential liability too broadly are particularly

relevant in securities cases. "'[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" *Id.* at 189 (citations omitted).

In this respect, it is ironic that Petitioner suggests certiorari should be granted because Section 10(b) liability presents "'an area that demands certainty and predictability, ...'" (Pet. at 10 (citing *Central Bank*, 511 U.S. at 188).) It would, however, have this Court articulate a new rule of law that would extend potential liability to parties who owe no current duty under the law. The Eighth Circuit acknowledged the dangers associated with such a view, noting that it was for Congress to first decide such matters. (*See* Pet. App. at 10a (recognizing that Petitioner's theory of liability "would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings.").) It is not, therefore, "critically important" to grant certiorari here to change the law in a direction that would be contrary to the Act and that has been rejected in prior decisions of this Court.

III. THE DECISIONS FROM OTHER COURTS CITED BY PETITIONER DO NOT SUPPORT GRANTING CERTIORARI

The *Charter* decision is consistent with the Act and this Court's prior decisions. Petitioner's certiorari request asks this Court to depart from prior precedent and embrace the decisions of certain district courts and a decision

of the Ninth Circuit that purport to adopt new standards of liability. (*See, e.g.*, Pet. at 18-20.)[10]

The cases on which Petitioner relies are not persuasive for the reasons outlined above. They are in conflict with this Court's prior rulings, are inconsistent with the text and purpose of Section 10(b), and authorize recovery where all the mandatory requirements of a Section 10(b) claim cannot be satisfied. They do not, therefore, provide a basis for granting the Petition.

The following decisions from courts, other than this Court, support the Eighth Circuit's interpretation of Section 10(b) and *Central Bank*: *Fidel v. Farley*, 392 F.3d 220 (6th Cir. 2004); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194 (11th Cir. 2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998); *Dinsmore v. Squadron, Ellenoff, Plesant, Sheinfeld & Sorkin*, 135 F.3d 837 (2d Cir. 1998); *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996); *Dutton v. D&K Healthcare Resources*, No. 4:04CV147SNL, 2006 WL 1778863 (E.D. Mo. June 23, 2006); *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804 (S.D. Tex. 2004); *In re Bristol-Myers Squibb Sec. Litig.*, 312 F. Supp. 2d 549 (S.D.N.Y. 2004); and *In re Livent, Inc. Noteholders Sec. Litig.*, 174 F. Supp. 2d 144 (S.D.N.Y. 2001).

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[10] The Ninth Circuit apparently does not believe that its decision in *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), is in conflict with *Charter*. *See Simpson*, 452 F.3d at 1050 (citing *Charter* in support of the point that "[p]articipation in a legitimate transaction, which does not have a deceptive purpose or effect, would not allow for a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud.").

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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October 20, 2006

JURY TRIAL DEMANDED

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

IN RE CHARTER COMMUNICATIONS, INC. SECURITIES LITIGATION	**MDL DOCKET NO. 1506 (CAS) ALL CASES**
STONERIDGE INVESTMENT PARTNERS LLC, Individually and On Behalf of All Others Similarly Situated,	**Consolidated Case No. 4:02-CV-1186 CAS**

Plaintiff,

v.

CHARTER COMMUNICATIONS, INC., PAUL ALLEN, JERALD L. KENT, CARL E. VOGEL, KENT KALKWARF, DAVID G. BARFORD, PAUL E. MARTIN, DAVID L. McCALL, BILL SHREFFLER, CHRIS FENGER, JAMES H. SMITH, III, SCIENTIFIC-ATLANTA, INC., MOTOROLA, INC. and ARTHUR ANDERSEN, LLP,

Defendants.

AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATIONS OF FEDERAL SECURITIES LAW

(Filed Aug. 5, 2003)

Lead Plaintiff, by its attorneys, for its Consolidated Class Action Complaint alleges the following upon personal

knowledge as to itself and its own acts, and upon information and belief based upon the investigation of Lead Plaintiff's attorneys as to all other matters. The investigation included the thorough review and analysis of public statements, publicly filed documents of Charter Communications, Inc. ("Charter" or the "Company"), press releases, news articles, and the review and analysis of accounting rules and related literature.

The investigation also included extensive interviews with numerous former Charter employees from offices in virtually all regions in which the Company does business. Such employees include individuals who held varied and diverse positions with the Company: directors of operations and marketing, accounting managers, technical supervisors and customer service representatives. The allegations set forth herein reflect specific and credible information provided by such individuals regarding Charter's ongoing practices, which were often corroborated by multiple employees.

SUMMARY OF ACTION

1. This is a securities class action on behalf of investors who purchased the securities of Charter during the period from November 8, 1999, through July 17, 2002 (the "Class Period"). Lead Plaintiff complains of a fraudulent scheme that injured purchasers of Charter stock during the Class Period.

2. Charter is headquartered in St. Louis, Missouri and purports to be the nation's fourth largest cable operator.

3. From the outset of the Class Period, Defendants portrayed Charter as a booming company which was experiencing a steady internal growth rate of new subscribers (in contrast to new customers from acquired companies), along with increased operating "cash flow" and reduced losses. Indeed, the Company boasted that its 2+% internal growth rate for new customers was the highest of the nation's large cable companies, and that it was likewise a leader in "operating cash flow" growth.

4. In order to maintain this upbeat image, defendants engaged in a pervasive and continuous fraudulent scheme intended to artificially boost the Company's customer base and reported financial results. But for this scheme, Charter would have reported no net increase in customers from internal growth. Moreover, Charter's critical growth rate of operating cash flow was materially inflated during 2001, and was only half the amount publicly reported.

5. Among other things, defendants inflated Charter's internal customer growth rate by deliberately delaying "disconnects" for over 100,000 customers who were no longer paying their bills, or who had advised the Company they wished to terminate their service.

6. In addition, defendants materially inflated Charter's operating cash flow by improperly capitalizing labor-related and other costs that should have been expensed. Defendants also improperly recognized up front all revenues received in connection with the launch of new programming channels, rather than spreading such revenues over the term of the programming contract.

7. As a further device to inflate the Company's reported performance, Charter entered into kickback

arrangements with defendants Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola'), the suppliers of key components for use by Charter's customers. During the fourth quarter of 2000, Charter agreed to pay Scientific-Atlanta and Motorola an additional $17 million for digital set-top boxes used by cable customers above and beyond the amounts ordinarily charged for such components. In exchange for these defendants agreed to kickback all those additional monies to Charter in the form of "advertising fees." Charter booked the payments to Scientific-Atlanta and Motorola as capital expenditures (which were then depreciated over the life of the equipment, and thus not included in Charter's reported "operating cash flow" figures), while it improperly booked the "advertising fees" received from Scientific-Atlanta and Motorola as revenue (rather than a direct set-off against costs), thereby inflating revenues and cash flow.

8. As a result of these fraudulent accounting practices, Charter's reported revenues and operating cash flow were materially inflated, and its losses were materially understated.

9. Defendants engaged in this multi-prong scheme for one purpose – to "meet the numbers" that Wall Street had projected for Charter, and thereby boost the price of the Company's stock, enabling it to acquire other companies using its inflated stock as currency.

10. As a result of these illegal practices, Charter's stock price rose to an artificial Class Period high of $26.31 per share.

11. On July 17, 2002, analysts voiced skepticism regarding some of Charter's accounting practices. Shortly thereafter, on August 16, 2002, the Company revealed that

a federal grand jury was conducting a criminal probe of Charter's accounting for capital expenses, and its inflating the number of customer accounts. This followed the write-off of 145,000 customers by Charter earlier in the year, effectively wiping out all the previously reported internal subscriber growth.

12. On October 22, 2002, the Company announced that, due to the pendency of the Grand Jury proceedings, it was placing its Executive Vice President and Chief Operating Officer, defendant David G. Barford, on paid leave.

13. Subsequently, on December 23, 2002, the Company announced that both Barford and the Company's Chief Financial Officer, defendant Kent D. Kalkwarf, had been fired following an internal investigation of various matters, including those related to the Grand Jury investigation. The Company also stated that its books and records for the years 2000 and 2001 were being reaudited by the Company's new accountants, KPMG LLP, who had replaced defendant Arthur Andersen LLP.

14. On February 10, 2003, it was publicly disclosed that the Grand Jury investigating Charter had subpoenaed records from Scientific-Atlanta.

15. On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. The Company acknowledged for the first time that its "operating cash flow," otherwise known as earnings before interest, taxes, depreciation and amortization ("EBITDA"), had been inflated for 2001 by 19.5% ($292 million), and for 2000 by 14.5% ($195 million). Most significantly, the Company acknowledged for the first time that whereas it

had reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount.

16. The foregoing fraudulent practices materially inflated Charter's stock price. Increasing skepticism regarding the accuracy of the Company's prior disclosures caused Charter's stock price to fall from over $20 in late 2001, to less than $10 by July 2002. Following the disclosure of the Grand Jury Investigation, the price plummeted, falling to a 52-week low of $0.76 on October 11, 2002, down approximately 97% from its Class Period high.

17. On July 24, 2003, the Grand Jury returned an indictment ("Indictment") against four of the defendants – David G. Barford, Kent D. Kalkwarf, David L. McCall and James H, Smith, III, charging that they "knowingly devised and intended to devise a scheme to defraud investors in Charter securities." The Indictment focused specifically on deliberate inflation of Charter's customer count, and the kickbacks from Scientific-Atlanta and Motorola. On July 25, 2003, defendant McCall entered a guilty plea, signed a Plea Agreement, Guidelines Recommendations and Stipulations ("Plea Agreement"), and acknowledged in Court that he had been instructed to inflate subscriber counts.

JURISDICTION AND VENUE

18. This Court has jurisdiction over this action pursuant to Section 27 of the Securities Exchange Act of 1934 (the "1934 Act"), 28 U.S.C. §§ 1331 and 1337. The claims asserted herein arise under Section 11 of the Securities Act of 1933 (the "1933 Securities Act"), 15 U.S.C. § 77 (k); Section 12 of the 1933 Securities Act, 15

U.S.C. § 77(l); Section 15 of the Securities Act, 15 U.S.C. § 77(o); Sections 10(b) and 20(a) of the 1934 Act, 15 U.S.C. §§ 78j(b) and 78t(a); and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder by the SEC.

19. Venue is proper in this District pursuant to Section 22 of the 1933 Act, 15 U.S.C. § 77(v); Section 27 of the 1934 Act, 15 U.S.C. § 78aa; and, 28 U.S.C. § 1391(b). Many of the Charter Related Defendants reside in this District. Many of the acts giving rise to the violations complained of, including the dissemination of false and misleading public statements and financial information, occurred in this District.

20. In connection with the wrongs alleged herein, Defendants used the instrumentalities of interstate commerce, including the United States mails, interstate wire and telephone facilities, and the facilities of the national securities markets.

THE PARTIES

21. Lead Plaintiff StoneRidge Investment Partners LLC purchased shares of Charter common stock in the Company's Initial Public Offering on November 8, 1999, and during the Class Period, as set forth in its previously filed Certification, and was damaged thereby.

22. Defendant Charter is a Delaware corporation whose headquarters are located at 12405 Powerscourt Drive, St. Louis, Missouri 63131. Charter is a cable operator that provides video, data, interactive and private business network services to purportedly seven million customers in forty States through the Company's broadband network of coaxial and fiber-optic cable. The Company

offers traditional analog cable as well as digital television services, along with an array of advanced products and services such as high-speed Internet access, interactive video programming and video-on-demand. By the end of the Class Period, Charter's customer base was approximately 7 million. As of May 24, 2002, Charter had 294,647,000 shares of common stock outstanding. Charter's shares trade on the Nasdaq National Market under the symbol "CHTR."

23. Defendant Paul Allen ("Allen") is the founder, Chairman and controlling shareholder of Charter. Defendant Allen owns 56% of Charter's outstanding shares through a holding company, Vulcan Ventures Incorporated, which is entitled to all of Charter's tax losses.

24. Defendant Jerald L. Kent ("Kent") was the President, Chief Executive Officer and director of Charter from July 1999 through the time of his resignation, which was effective as of September 28, 2001. Kent had previously served as Chief Financial Officer of Charter Investment, Inc., a predecessor to, and affiliate of, the Company. From 1979 to 1983 Kent worked in the Tax Division of Arthur Anderson.

25. Defendant Carl E. Vogel ("Vogel") became Charter's President and Chief Executive Officer, and a director of the Company, in October 2001.

26. Defendant Kent Kalkwarf ("Kalkwarf") was, during the Class Period, Executive Vice President and Chief Financial Officer ("CFO") of Charter. Kalkwarf was formerly a partner of defendant Arthur Andersen LLP. Defendant Kalkwarf has been indicted by the Grand Jury investigating Charter's misconduct.

27. Defendant David G. Barford ("Barford") was, during the Class Period, Executive Vice President and Chief Operating Officer of Charter. Defendant Barford has been indicted by the Grand Jury investigating Charter's misconduct.

28. Defendant Paul E. Martin ("Martin") was, during the Class Period, Senior Vice President and Corporate Controller (Principal Accounting Officer).

29. Defendant David L. McCall ("McCall") was, during the Class Period, Senior Vice President of Operations for Charter's Eastern Division. In addition to his salary, McCall was a member of a partnership that received $177,600 in 2001 for office space leased to Charter. In addition, in 2001, Charter paid $571,533 to a construction company controlled by McCall's brother and $462,071 to a construction company controlled by McCall's son. Defendant McCall has been indicted by the Grand Jury investigating Charter's misconduct, and has entered a guilty plea.

30. Defendant William Shreffler ("Shreffler") was, during the Class Period. Senior Vice President of Operations for Charter's MidWest Division.

31. Defendant Chris Fenger ("Fenger") was, during a portion of the Class Period, Senior Vice President of operations for Charter's Western Division.

32. Defendant James H. Smith, III ("Smith") was, during a portion of the Class Period, Senior Vice-President of Operations in charge of Charter's Western Division. Defendant Smith has been indicted by the Grand Jury investigating Charter's misconduct.

33. Defendants Allen, Kent, Vogel, Kalkwarf, Barford, Martin, McCall, Shreffler, Fenger and Smith are sometimes referred to herein as the "Individual Defendants." Collectively with Charter, the Individual Defendants are referred to as the "Charter Related Defendants."

34. Defendant Scientific-Atlanta, Inc. ("Scientific-Atlanta") is based in Atlanta, Georgia, and is one of the nation's leading manufacturers of electronic equipment, including digital set-top boxes for use in the cable industry. A digital set-top box is equipment that is placed on a subscriber's television enabling it to receive and view digital television. Charter purchases this equipment and supplies them to its customers so they can view Charter's cable television programs.

35. Motorola, Inc. ("Motorola") is based in Schaumburg, Illinois, and is one of the nation's leading manufacturers of electronic equipment, including digital set-top boxes for use in the cable industry.

36. Defendant Arthur Andersen LLP ("Arthur Andersen") is an accounting firm headquartered in Chicago, Illinois, which served as Charter's independent auditor during the Class Period.

BACKGROUND

Charter's Corporate Structure

37. During the Class Period, Charter was headquartered in St. Louis, Missouri, where all statements issued to investors were prepared and disseminated. Through 2000, Charter was divided into two operating "divisions," the Eastern and Western Divisions. Defendant McCall was the Senior Vice President of Operations for the Eastern

Division. In 2001, the Western Division was divided into the (i) Midwest and (ii) Western Divisions, at which time it was headed by Senior Vice Presidents, defendants (i) William Shreffler and (ii) Chris Fenger and James Smith, III. Each of the Senior Vice Presidents for the Divisions were featured in Charter's Annual Reports. Within each of the Divisions there were several "Operating Regions," of which there were 10-12 altogether.

38. The Divisions, Regions, and individual offices of Charter were linked through two centralized computer systems, known as "Cable Data" and "CSG," that tracked all customer account and billing information.

39. Accounting personnel at Charter's Western Division office, located in Denver Colorado, collected and compiled financial data from the local and regional offices and forwarded the results to corporate accounting at Charter's headquarters in St. Louis. Defendant Kalkwarf, the Chief Financial Officer and defendant Martin, the Vice President of Accounting, supervised the final compilation of Charter's financial numbers in St. Louis.

The Importance of Operating Cash Flow EBITDA and Customer Growth in the Cable Industry

40. During the late 1990s, cable companies went through a period of significant capital investment and consolidation. Companies installed wire cable networks at significant expense, while also acquiring smaller companies. During this period, it was not unusual for cable companies' expenses to exceed revenues. For stock market analysts who followed the industry, though, the short term losses were not important so long as the companies were

building solid customer bases while sustaining a significant positive cash flow growth rate.

41. Critical to the assessment of the strength of a cable company's customer base was the degree to which it grew internally (rather than through acquisitions). Such growth indicated that customers were pleased with services and were not defecting. This became particularly critical as the cable companies faced stiff competition from satellite television companies, which did not rely upon costly underground wire cable systems.

42. "Operating cash flow" was also an important measure of cable companies' performance. Technically known as "EBITDA," operating cash flow was a commonly used alternative means of gauging the quality of a company's performance. Until recently, EBITDA was also perceived to be a more reliable measurement of the company's results, since it reflected the company's core operating costs during any period (rather than capital investments whose benefits would be realized over a longer time frame). Cable industry companies and analysts tended to use the terms EBITDA and "operating cash flow" interchangeably.

Generally Accepted Accounting Principles Applicable to Cable Companies

43. Given the significance assigned operating cash flow, it was critically important whether a company expensed certain costs, or capitalized them over a period of time (in which case they were excluded from operating cash flow). Generally Accepted Accounting Principles ("GAAP") govern the accounting for such costs and the determination of whether they are expensed or capitalized.

44. Financial Accounting Standard ("FAS") 51 governs the standards for accounting on specific issues related to the cable industry. Among other things, FAS 51 states:

> a. Labor costs associated with installing new services on the *first visit* to an address can be capitalized, and then depreciated over a period no longer than the period used to depreciate the cable television plant.
>
> b. A portion of associated "indirect" costs, that are associated with installation or upgrade labor costs may likewise be capitalized.
>
> c. The costs of subsequently disconnecting or reconnecting a subscriber (or an address) must be expensed. Thus, the second time a service is enabled at an address (even if it is a new subscriber), it must be expensed in the period incurred.
>
> d. "Subscriber related costs" and general administration expenses must be expensed in the period incurred. These costs include:
>
> > Cost of billing and collection, bad debts, mailings, repairs and maintenance of taps and connections, general and administrative systems costs such as salary of the system manager and office rent, programming costs for additional channels used in the marketing effort or costs related to revenues from per channel or per program service, and direct selling costs.

Charter's Accounting Policies

45. Throughout the Class Period, Charter's *stated* accounting policy for expenses conformed to GAAP. That *stated* policy was:

> Costs capitalized as part of new *customer installations* include materials, subcontractors costs, internal direct labor costs, including service technicians and customer care representatives and internal overhead costs incurred to connect the customer to the plant from the time of installation scheduling through the time service is activated and functioning. We capitalize incremental and direct contract acquisition costs to the extent realizable from future revenues. The overhead rates established are based on a combination of internal company-wide overhead analysis and internal time and motion studies of specific activities. These studies are updated to adjust for changes in facts and circumstances. . . . The *costs of disconnecting and reconnecting* a customer are charged to expense in the period incurred. *Expenditures for repairs and maintenance* are charged to operating expense as incurred, while equipment replacements and betterments, including the replacement of drops, are capitalized. [Emphasis Supplied].

46. While the Company's stated policy conformed to GAAP, in actual practice, as discussed below, the Company consistently violated its own policy and GAAP by arbitrarily capitalizing material portions of certain labor related expenses in order to artificially enhance its operating cash flow results in line with Wall Street's expectations. This dovetailed with Charter's fraudulent inflation of its internal customer growth rate, also detailed below.

47. The favorable, though fraudulent, results that Charter disseminated during the Class Period were intended to enable the Company to meet analysts' forecasts and thereby prop up the price of Charter stock. In turn, this enabled the Company to continue to use its stock as valuable currency on its acquisition spree. In 1999 and 2000 alone, Charter completed sixteen acquisitions. Such transactions include: (i) the acquisition of Bresnan Communications Company (involving cable systems in Michigan, Minnesota, Wisconsin and Nebraska) for approximately $3.1 billion, in which $1.0 billion in Company equity was utilized to finance such purchase price; (ii) a stock for stock merger with Cablevision of Michigan, Inc., a cable system in Kalamazoo, Michigan, in which Charter issued Class A common stock purportedly valued at approximately $170.6 million; and, (iii) the acquisition of several cable systems from Cable USA, Inc., and its affiliates for a total purchase price of $100.3 million, financing more than one-half of such purchase ($55.7 million) with the Company's Series A Convertible Redeemable Preferred Stock.

THE FRAUDULENT SCHEME

48. Throughout the Class Period, defendants Kalkwarf and Barford were principally responsible for making sure that the Company met Wall Street's expectations, regardless of whether doing so reflected Charter's true operating and financial condition. These defendants instructed lower level personnel, including the senior operating officers of each division, to utilize certain fraudulent techniques to insure that the "numbers" were indeed "met." In order to accomplish these ends, defendants Kalkwarf and Barford instructed other personnel to

inflate the customer counts and arbitrarily capitalize certain costs. In addition, as discussed below, defendants Kalkwarf and Barford engaged in kickback arrangements with Scientific-Atlanta and Motorola for the sole purpose of materially inflating Charter's revenue and operating cash flow.

Inflation of the Customer Counts and Internal Growth Rates

49. As discussed above, Charter touted its 2+% internal growth rate as being the best in the industry. To meet this rate, the Company had to annually add up to 140,000 new customers to its subscriber base by means other than purchasing other cable companies.

50. Analysts were enamored with the Company because of this growth rate. As a Credit Suisse analyst commented in a report issued on May 14, 2002: "Charter has historically been one of the fastest-growing cable MSO's owing to industry-leading basic sub[scriber] growth. . . ." It also meant that Charter was successfully confronting the increased competition from satellite television companies.

51. This appearance of internal growth was a fraudulent illusion created by defendants to cover up the absence of any genuine internal customer growth. But for this scheme, Charter would have reported that the internal customer growth rate was flat, rather than 2+%. Plaintiffs' investigation indicates that this scheme was long-standing and grew exponentially throughout the Class Period. The Grand Jury charged that the *criminal* scheme to inflate subscribers commenced "in or about May 2001" when "it became clear to defendants that Charter

would not reach its second quarter subscriber growth projections if its normal business practices for disconnecting customers were followed."

52. Pursuant to this scheme, defendants Kalkwarf and Barford instructed employees during weekly conference calls and in other communications to "manage" disconnects of customers in order to reach subscriber growth rate estimates projected by Wall Street analysts.

53. Among other things, Charter personnel inflated the customer count by the following fraudulent techniques:

a. Whenever a customer requested termination, or was otherwise 60 days or more behind in payments, the customer should have been disconnected and/or no longer counted in the subscriber base. In order to avoid the adverse impact this would have had on reported figures, Charter personnel routinely were told to "hold disconnects," that is, to not process the paperwork for the termination. Company-wide, this amounted to over 100,000 customers during the Class Period. These terminations, if treated properly, would have wiped out all of the Company's reported internal customer growth rate.

b. At the beginning of the Class Period, the practice was to hold disconnects until after the close of the quarter, to enable Charter to make its numbers, and then to process the terminations. Each quarter's internal growth figures was materially inflated by the failure to exclude these customers who the Company knew were no longer paying for the service. As the Class Period progressed, the period for holding disconnects was extended beyond the end of one quarter, and cumulatively expanded.

c. Charter personnel were also instructed to hold the disconnects of customers who had been given 3-6 months of free trial service, but had refused to pay after the end of the trial period. Nonetheless, during the free trial period, Charter assigned a nominal fee to these accounts in order to include them as paying subscribers, even though the Company did not generate a bill for these accounts and did not receive any revenue from them.

d. Charter personnel were instructed to routinely double-count customers if they (i) moved from one location to the next (counting both their prior and new location); (ii) upgraded their account (counting the old service and the additional service separately); and/or (iii) reactivated service (counting the prior service and the reactivated service separately).

e. Charter personnel were instructed to routinely misclassify its cable customers in order to paint a false picture of internal growth. Charter offered customers its basic cable package, or alternatively, just access to the Internet (data access, or digital-only customers). The former were much more desirable, since charges for the basic package were considerably higher than Internet access only. Charter thus routinely: (i) included 50% of the monthly fee paid by digital-service-only customers in the basic cable revenues; and, (ii) included such digital-only customers in the total count of the basic cable customers. This enhanced the false appearance of the Company's customer growth rate.

f. As further evidence of the fraudulent nature of this overcounting scheme, Charter offices routinely maintained two sets of books regarding customer counts: (i) the first set included the inflated numbers, which

incorporated "holds" on disconnects and other devices which overstated Charter's true subscriber count (but reached the "quota" assigned to that office), and were passed on to corporate headquarters; and, (ii) the second set, which contained the actual, lower numbers, which were utilized to calculate employee bonuses.

g. By way of example, during the period 1999 through 2002, Charter's offices in Georgia actively engaged in hold disconnects practices. Sometimes customers were disconnected in the field, but the disconnect was not processed in the Company's billing system. Other times, customers were not even disconnected in the field. Such disconnects were held until the local office turned in its subscriber count and financial reports to the regional offices at the end of each quarter, after which the disconnects were processed.

54. Even though customers slated for disconnection were not paying, or had requested termination, Charter continued to routinely bill them. To avoid complaints from customers who had requested termination, but whose disconnects were subject to "holds," Charter resorted to issuing bills to these customers but changing the mailing address to Charter's own offices. This enabled the Company to record the customers as active (and record their bills as payable). Such examples include:

a. Starting in July 2001, Charter's General Manager in Columbia, Tennessee, Don Grammar, following instructions that were received from headquarters, ordered his office to generate and mail out phony bills for terminated customers (as it had previously), but to change the addresses on such bills to Charter's *own* office instead of the customer. In some cases, the bills and envelopes

were also addressed "ATTN DON," reflecting the name of the General Manager.

b. When an employee in the Columbia, Tennessee office raised questions about the legality of the inflated subscriber counts, she was told by the General Manager's administrative assistant that *corporate headquarters* was ordering all of its offices to delay processing the disconnects. Copies of such bills are attached.

55. Some offices took the fraudulent invoices process one step further, and created fictitious accounts with invoices mailed to Charter offices. For example:

a. In its Duluth, Georgia offices, a senior officer instructed customer service representatives to create such phony billings, have them mailed out to a Charter address so that they would be returned to Charter, and locked in the filing cabinet in his office. Fictitious customer names, such as "Jack Daniels" and "Dale Earnhardt," were utilized in such a scheme.

b. False subscriber accounts were also created at Charter's Stockbridge, Georgia offices at the direction of Phil Skinner, the General Manager and Director of Operations for Charter's Southern Region.

56. Several Charter employees, including defendants McCall and Smith, raised objections to the practice of holding disconnects in order to meet projected subscriber numbers. Nonetheless, defendant Barford insisted that employees hold the disconnects in order to make the numbers. Despite their objections, Smith and McCall relayed these instructions to subordinates knowing that this would results in Charter publicly reporting materially inflated subscriber counts.

57. Charter made sure that its employees knew that this was the way the Company did business by quickly terminating any lower level personnel who questioned or complained about the policy:

a. When employees in the Maryville, Illinois office questioned these practices at a meeting in late 2001 or early 2002, they were threatened by the head of Human Resources with the loss of their jobs and the loss of any severance if they made any public disclosures of the above-described practices.

b. Some of these terminations involved generous severance packages that sought to preclude anyone from discussing the Company's illegal business practices with anyone. William Reilly (Charter's finance director for Georgia) was the beneficiary of such a package.

58. Other specific examples of instances where disconnects were delayed beyond the end of quarters so that Charter could "make its numbers" during 2001 include:

a. In weekly conference calls, Kalkwarf and Barford directed other Charter officers to inflate subscriber growth rates in order to meet internal and analysts' projections.

b. In response to these directives, defendant McCall, Vice President of Operations for the Eastern Region, specifically ordered Regional Directors in Georgia (Phillip Skinner, William Reilly and Michael Davolt) to hold disconnects until after the end of quarters. At the hearing on July 25, 2003 where he entered his plea of guilty to the indictment, defendant McCall admitted that he was "instructed to meet certain quarterly expectations"

about the number of subscribers, and further acknowledged that the scheme involved "a lot of people in the company."

c. In response to these directives, defendant Smith likewise ordered personnel to hold disconnects until the end of quarter during 2001. At a meeting that took place on September 14, 2001, that was attended by numerous Charter executives, defendants Barford and Kalkwarf presented information that Charter had, at the time, 60,000 to 90,000 "managed" disconnects, i.e., customers who had not paid their bills or had voluntarily terminated their accounts, and were due to be cut-off, but were not in order to enable Charter to make its subscriber count growth rate numbers.

d. On or about October 5, 2001, defendant Barford e-mailed employees at Charter's divisions instructing them to provide "basic net gain in 4Q to get to 1% and 1.4% growth rate for the year." Consistent with his plan to maintain a reserve of disconnects that could be used in the future to continue managing the subscriber count growth rate, Barford added, "[Then] tell me how many managed disconnects you would still have left over after getting to these numbers."

e. In response to these directives, in October 2001, defendant Shreffler, Vice President of Operations for the Mid-West Division, ordered all disconnects that were being processed in the field not to be processed in the data system. These instructions were conveyed throughout the Division to Charter's offices such as that in Maryville, Illinois (where Charter had been founded in 1993), with the instructions "complete it in the field, but hold the paperwork."

f. Consistent with Barford's October 4, 2001 directive, throughout the fourth quarter of 2001, the Maryville, Illinois system alone had approximately 2,400 customers who had either requested disconnects or had already been physically disconnected, but who were still being counted in the Company's subscriber base. This number can be verified by reviewing the "no truck" data reports in the CableData system during and immediately after the period. Indicative of the degree to which this practice inflated the reported subscriber growth rates, there were 50,000 total customers for the entire Maryville region. Thus, the amount of disconnects still counted as active customers totaled nearly 5%, which was over twice the reported internal customer growth rate for the entire Company.

g. Other Charter divisions likewise followed Barford's directive. In October, 2001, defendant Fenger, the Senior Vice President of Operations for Charter's Western Division, specifically ordered that the processing of all disconnects be halted for the remainder of the year. Fenger did so with the knowledge of, and indeed in response to, discussions with Kenneth Rhodes, a senior officer in Charter's management.

h. This directive was consistent with the policy Fenger had been enforcing for several years. When previously questioned by a district director of operations about this disconnect policy, Fenger bluntly replied "that's just how we do business."

i. On December 6, 2001, Barford e-mailed Kalkwarf and another senior Charter executive advising that "Basic [i.e. internal] growth for December should be over 60K holding discos."

j. In December 2001, an outside contractor for Charter (Cabletex) was specifically instructed to hold the 3,300 disconnects that were scheduled to be performed in the Dallas-Fort Worth market until after the close of the quarters. On another occasion, Charter personnel instructed Cabletex to hold any disconnects until after a shareholder's meeting.

k. The specific directive to hold disconnects in the Long Beach, California office in order to artificially boost subscriber counts came from the Senior Vice President for that Region and was consistent with what was happening throughout all of Charter's local and regional offices, as directed by corporate headquarters.

59. As 2001 drew to a close, Charter executives began discussing an exit strategy from this scheme, fully aware that the Company would have to purge from its rolls those customers who should have been written off long ago.

a. On December 7, 2001, Barford e-mailed Kalkwarf and stated: "We are trying to figure out how many we could disconnect in December and still be in line with others. Is .5% or .6% sellable without revising downward [guidance]."

b. In a December 2001 memo to defendant Barford, defendant Kalkwarf suggested that Charter might "bleed the disconnects in over time" or "take the hit in the first quarter on the call for the change in strategy." Kalkwarf concluded by stating: "We should still take a hit (140,000 customers times $3600 per customer is just under $1 per share) but at least we are running the business and we can argue that we did end the year at approximately 1%."

c. Shortly after, on December 10, 2001 Kalkwarf e-mailed Barford and a senior Charter executive urging that they "stick with original plan to get 61,000 net gain for December" which would "help us get revenue and cash flow for the year. . . ." In another e-mail of the same day, Kalkwarf further urged that:

> My thoughts are to discuss the issue in the first quarter of next year as we are going to take a hit for it no matter what and if we have 0 or negative growth this year after our statements of last week and earlier we will take two hits – one for customer growth and one for continued lack of [credibility].

d. The exit strategy was sealed in a December 21, 2001 e-mail by defendant Barford to defendant Kalkwarf and a senior Charter executive stating, "I want to give the field direction to dump all the voluntary and 120 day or greater nonpays right after cut [for the year end 2001]. . . ."

e. Charter personnel also sought to cover-up evidence of illegal practices immediately following the decision in early 2002 to write off over 125,000 accounts for which disconnects were on "hold." In Charter's offices in Duluth, Georgia, employees were instructed by Harold Collins, the Vice President and director of finance for the Georgia region, to shred financial documents and e-mails going back to 1998. Employees were told by another senior person in the office, Mark Marshall, that if they were asked about the practice of creating false bills "don't say anything."

Charter's Blatantly Improper Capitalization of Labor Costs, Overhead and Administrative Expenses

60. In addition to chronically inflating subscriber counts and revenues, defendants also distorted Charter's performance and profitability by improperly capitalizing certain costs (particularly labor costs) that should have been expensed, thereby materially inflating the Company's critical operating cash flow results. The purpose of this scheme was to create the illusion that, just as the Company's subscriber base was growing, so too were its earnings from such subscribers, as measured by operating cash flow/EBITDA.

61. But for this scheme, Charter's reported rate of operating cash flow growth would have been 6% for 2001 compared to 2000, rather than the 12.5% reported. The operating cash flow growth rate was also materially inflated for years 1999 and 2000.

62. The directives to capitalize portions of labor costs that GAAP required to be expensed originated with defendants Kalkwarf and Barford, who used Division and Regional officers to communicate the need to increase the rate of capitalization in order to avoid expected shortfalls in operating cash flow. As the Vice President of the Northeast Region wrote in a memorandum sent to all its offices during the Class Period, 35% of the salaries of customer service representatives had to be capitalized (rather than properly expensed) because the Company was "behind on the numbers."

63. Charter's widespread practice of capitalizing labor costs that should have been expensed not only violated GAAP as detailed in ¶¶ 43-44, *supra*, but was

inconsistent with its own policy as set forth in its public filings, particularly the portion related to repair and disconnection related expenses:

> The costs of disconnecting a customer are charged to expense in the period incurred. Expenditures for repairs and maintenance are charged to operating expense as incurred, while equipment replacement and betterments are capitalized (*See* ¶ 45, *supra*.)

64. Charter's improper labor capitalization practices were applied to several areas:

a. Virtually all labor-related costs were capitalized to some degree depending on the amount needed to make up the expected operating cash flow shortfall, even though GAAP only permitted capitalization of new customer installation costs.

b. Charter arbitrarily capitalized a significant portion of certain technician labor costs associated with (i) customer upgrades to digital service; (ii) repairs on installation; and, (iii) changes to splitters (devices in the home that divides a signal into multiple paths), when all such costs should have been expensed.

c. Charter routinely capitalized significant portions of the salaries related to customer service representatives, and large portions of management salaries as well. Both of those types of costs should have been expensed.

d. Charter routinely capitalized significant portions of "reconnect" costs (reconnecting subscribers who had requested that their cable be disconnected or whose service had been terminated for failure to pay their bills).

The percentage of capitalization changed from month to month, depending on the amount of savings needed to meet cash flow expectations. In the Duluth, Georgia office, 75% of these costs were capitalized during the Class Period.

e. These improperly capitalized costs totaled $93 million in 2001 and $52 million in 2000.

f. In order to further improperly capitalize costs, the Company also had outside contractors directly pay distributors for supplies and similar items, and then had the contractors include the costs of such goods in the bill for contractors' services. Charter then capitalized the entire cost as "outside contracting," when in fact the items paid for by the contractors were strictly for Charter's use and should have been expensed.

g. At the direction of regional officers, including John McFerron, the Regional Vice President of Finance for Charter's North Central region (based in Madison, Wisconsin), Charter offices also improperly capitalized 100% of the labor costs associated with its Internet Division. Offices compounded this inflation by shifting additional employees into the Internet division to maximize the capitalization of labor costs.

h. Charter also paid third-party contractors to conduct marketing campaigns. The Company improperly deferred the cost of these services rather than expensing them as incurred. As a result, $59 million in marketing campaign expenses were improperly deferred rather than expensed in 2001. Such accounting for marketing campaigns was in direct violation of Statement of Position 93-7 ("SOP 93-7"), *Reporting on Advertising Costs*, which governs

the accounting for advertising costs under GAAP. SOP 93-7 states the following:

> The costs of advertising should be expensed either as incurred or the first time advertising takes place except for:
>
> a. Direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits (future benefits). Examples of the first time advertising taking place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.
>
> b. Expenditures for advertising costs that are made subsequent to recognizing revenues related to those costs.

65. Charter not only improperly capitalized the direct labor costs described above, but also improperly capitalized allegedly associated general and administrative overhead expenses. By way of example, John McFerron ordered that 47% of all general and administrative expenses be capitalized.

66. These percentages of labor and other costs that were capitalized were unrelated to the amount of time or portion of expenditures that were appropriately spent on customer implementation related services, but instead related strictly to the amount of the operating cash flow shortfall that Charter personnel were instructed to cover.

67. As a result of this scheme, the amount of purportedly related overhead and administration costs that Charter capitalized per subscriber was nearly twice that of Charter's competitors.

68. While much of the implementation of the improper capitalization was done at the local level, a significant portion was also performed at a centralized location, in Charter's Denver, Colorado offices, where all the Company's regional and divisional reports were consolidated. Accounting personnel in this office were instructed to "skew the numbers" by moving costs from one account code (which was to be expensed) to another code (which was to be capitalized) in order to make up any cash flow shortfalls.

69. In addition, accountants in Charter's Denver offices also artificially kept down the Company's expenses by directing the regional offices to hold payments due for contract labor at the end of each quarter until the following quarter, or even later. By the end of 2001, for example, Crown Fiber, one of the Company's largest outside contractors, was owed approximately $5 million by Charter. Charter avoided recognizing this expense by deferring the payment and not recording any account payable.

70. Finally, Charter also improperly capitalized certain promotional costs for new programs which should have been expensed in the year incurred.

71. As a result of this improper capitalization of expenses, Charter's reported operating cash flow was materially overstated by at least $146 million in 2001, and by $87 million in 2000.

Manipulation of Revenues

72. In order to maintain the illusion of internal customer growth, Charter also had to show revenue growth consistent with such inflated customer counts. This was accomplished by manipulating the Company's centralized billing system. Under its own revenue recognition policies, Charter's monthly numbers were supposed to represent sales made from the 21st day of the month to the 21st day of the following month. Bills had to be mailed by the 21st of the month to have their charges booked as revenue for the month.

73. Billing results for those offices using the CSG billing system (which were only a small percentage) reflected the amount of bills actually sent by the 21st of each month (because the system had a hard-coded month-end cut-off date set for the 21st of each month). However, the vast majority of the Company's offices, those using the Cable Data billing system, had their closing extended to the 1st or 2nd day of the following month unless it was the end of the quarter, in which case Charter headquarters extended the billing cut-off date for regional offices by four or five days.

74. Charter also inflated its revenues by including all new program "launch fees" paid by suppliers at the outset of program contract period, rather than amortizing such fees over the entire term of the contract.

Charter Entered Sham Arrangements with Defendants Scientific-Atlanta and Motorola Intended To Artificially Boost Charter's Revenues and Operating Cash Flow

75. By way of background, in order to provide digital cable television service, it was necessary for Charter to

purchase digital cable converter boxes for installation in customers' homes. Purchases of these digital cable converter boxes became a large capital expense for Charter, and made Charter important customers of defendants Scientific-Atlanta and Motorola, the nation's two largest manufacturers of such converter boxes and other equipment used by cable companies.

76. In August, 2000, defendants Kalkwarf and Barford realized that the Company was facing a year-end short fall in operating cash flow relative to amounts projected by Charter and those analysts who covered the Company. In order to help cover that shortfall, the Company entered into sham agreements for "advertising" from defendants Scientific-Atlanta and Motorola to inflate Charter's operating cash flow for the fourth quarter of 2000.

77. As part of these sham transactions, Charter agreed to pay Scientific-Atlanta and Motorola an additional $20 for each digital converter so long as the suppliers repaid that same amount to Charter in the form of "advertising." Thus, the price increases paid by Charter and "advertising" payments made by the vendors constituted "wash" transactions with no economic substance.

78. Although these sham agreements could have no legitimate effect on Charter's operating cash flow, defendants exploited such transactions by fraudulently accounting for them in such a way as to significantly and artificially inflate Charter's operating cash flow during the Class Period, to wit, by treating the "payments" from Scientific-Atlanta and Motorola as "revenues" when in fact they were simply the return of Charter's own monies.

79. On the other hand, Charter avoided any adverse effect or decrease on its operating cash flow by capitalizing the payments made to Scientific-Atlanta and Motorola, under the pretext that they were related to the purchase of equipment. Thus, although the advertising payments had no economic effect whatsoever on Charter, through their misleading and fraudulent accounting for the transactions, the defendants used them to artificially increase Charter's publicly disclosed operating cash flow by at least $17 million dollars during the fourth quarter of 2000. But for this scheme, Charter's reported revenues and operating cash flow would have fallen short of analyst expectations.

80. Indicative of the deliberately fraudulent nature of these transactions, defendant Kalkwarf discussed the concept with defendant Arthur Andersen, the Company's outside auditors, in August 2000, prior to any payments being exchanged. At the time, Arthur Andersen stated that Charter could not recognize the advertising payments as revenue because they appeared integrally related to the cost increases being paid by Charter. Arthur Andersen counseled that Charter could recognize the advertising fees as revenues if the additional payments for the converter boxes and the advertising were: (i) at fair market value, (ii) unrelated to one another, and (iii) negotiated at least a month apart. In late August 2000, defendant Kalkwarf advised Arthur Andersen that Charter would fulfill those conditions. In September 2000, Kalkwarf falsely told Arthur Andersen that the advertising and supply contracts with Scientific Atlanta and Motorola had been negotiated by two separate departments at Charter a month apart from one another. To lend further credibility to these claims, even though the set-top box price increases were not finalized with either vendor until late

September 2000, the contracts were back dated to August 2000 on the instructions of defendants Barford and Kalkwarf. This gave the false appearance that the set-up box price agreements were negotiated a month before the advertising contracts which were dated in late September.

81. Despite being aware that Charter was seeking to generate additional revenue through a series of questionable transactions with these two vendors, Arthur Andersen accepted the explanations provided by Kalkwarf and Barford, and failed to perform further audit checks (e.g., requesting additional verification from the vendors) as it was required to do under Generally Accepted Auditing Standards.

82. As noted earlier, on February 10, 2003, Scientific-Atlanta disclosed that it had been subpoenaed by the Grand Jury. Scientific-Atlantic had been previously charged with entering into similar sham transactions with another notorious cable company, Adelphia Communications, Inc. The Indictment returned by the Grand Jury investigating Charter detailed this scheme, though it did not identify Scientific Atlanta or Motorola by name.

Defendants' Direct Participation in and Knowledge of the Fraud

83. Defendants Kalkwarf and Barford were directly involved in orchestrating directives in the Company to ensure that Wall Street estimates were met, and negotiating the sham transactions with Scientific-Atlanta and Motorola. They were fired because of their involvement in the fraudulent scheme. They have since been indicted by the Grand Jury.

84. Defendant McCall, Senior Vice President for the Eastern Division, was also actively involved in implementing the "hold disconnects" practice. An e-mail from Josh Jamison, one of the Regional Vice Presidents, to employees in the Massachusetts region, requiring that the Company hold all disconnects under 90 days past due, resulted from a meeting between defendant McCall and Jamison. In his Plea Agreement dated July 25, 2003, defendant McCall admitted he was directed to hold or postpone disconnects in order to "meet the forecasted numbers" for the subscriber growth rates that Charter had publicly projected for the second, third and fourth quarters of 2001. McCall further admitted in his Plea Agreement that in response to these directives, he:

> a. [G]ave instructions to hold disconnects to each of the regional vice presidents working below him. Soon after the end of the second, third and fourth quarters of 2001, these held disconnects would then be disconnected or "cleaned-up."
>
> b. [K]new that the purpose of holding these disconnects before the end of the quarter and then cleaning up disconnects afterward was to inflate Charter's quarterly growth in subscriber numbers that were intended to be reported to the public. During these quarters, without the holding of disconnects, Charter would not have been able to meet its quarterly subscriber forecasts.

85. Defendant Smith has been indicted by the Grand Jury for instructing subordinates to hold disconnects during the second, third and fourth quarters of 2001 "knowing that these instruction would result in Charter

reporting inflated subscriber numbers to the investing public."

86. In response to the directives received from Charter's corporate senior officers, the senior officers of Charter's two (and subsequently three) Divisions informed regional personnel of the steps to be taken to ensure those numbers were met. By way of example, defendant Shreffler, the Senior Vice President of Operations for the Mid-West Division told his assembled staff at an "all employee" breakfast held on May 23, 2001, that he was brought in to bring the numbers up: "whatever it takes to get the numbers up . . . It will happen no matter what, no matter what it takes."

87. Defendant Shreffler directed all of his system managers to ensure that there would be "no disconnects" at the end of the quarters and when shareholder meetings were scheduled. This was intended to create the appearance that the Company's subscriber base was healthy and growing. Shreffler's employees were instructed to keep track of the disconnects by maintaining a handwritten list, so as to avoid any record of actual or pending disconnects in the computerized billing system. In October, 2001, defendant Shreffler ordered that all disconnects were not to be processed in the system.

88. Defendant Shreffler had worked his way up the ranks at Charter (initially in Denver and Minnesota regional offices) utilizing these same techniques, and was rewarded by senior corporate officials until he rose to head one of the Company's three divisions. Defendant Shreffler, known as "Coach" by his subordinates, accepted nothing less than the goals or quotas that were set by corporate

headquarters, refusing to accept numbers that fell short and telling employees to "make it work."

89. Consequently, when a customer service manager in the Central Division was asked by another employee why he was changing subscriber numbers, he replied that he wasn't going to give "Coach" numbers that he didn't like, and was "making the stockholders happy." This was consistent with Shreffler's own practices. When he became Senior Vice President of the Central Division in the middle of 1999, the accurate count of subscribers was reported to him on a daily basis. If he did not like the numbers, he ordered them changed. This was done by entries into the centralized data system, CableData or CSG.

90. In October, 2001, defendant Fenger ordered all disconnects to be held until after the close of the year.

91. Defendants Allen, Kent and Barford were otherwise alerted to Charter's practice of holding disconnects by a certified mail letter dated April 19, 2001, from a Marketing Manager at Charter's Long Beach, California office, in which he asserted that he had been fired on the pretext of groundless sexual harassment charges made against him, when in fact the real reason for his termination was because he was "questioning the over 2000 disconnects that were pending at the time." No response was ever received, although the "whistleblowing" employee did receive confirmation of receipt of such letter. On information and belief, defendant Kent was also at the September 14, 2001 meeting that, as described in the Grand Jury's Indictment, was "attended by numerous Charter executives' at which defendants "Barford and Kalkwarf presented information that Charter had between 60,000 and 90,000 managed disconnects."

92. Defendant Allen, as Chairman and controlling shareholder of Charter was responsible for creating the culture at the Company that accepted nothing less than meeting the numbers to "keep shareholders happy." Allen knew that the appearance of customer and operating cash flow growth was essential in securing additional financing that was critical to his plan to build a cable empire. He demanded that Charter officers meet these goals and recklessly turned a blind eye to this misconduct. Indeed, when Kent signaled in September 2001 that the customer growth rate might decline, Allen promptly fired him.

93. Defendant Vogel, Charter's President after defendant Kent's departure in September 2001, was aware of the true reasons for the write-off of over 120,000 customers that Charter announced on February 11, 2002, but deliberately mischaracterized those reasons in order to divert attention from the Company's prior fraudulent misconduct. *See* ¶ 136 (a)-(c), *infra*.

94. The Individual Defendants were otherwise aware of, or recklessly disregarded, the fraudulent scheme by virtue of their positions as senior operating and financial personnel in the Company.

DEFENDANTS' MISLEADING PUBLIC STATEMENTS AND MATERIAL OMISSIONS DURING THE CLASS PERIOD

The Misleading Nature Of The Statements

95. As detailed below, throughout the Class Period, Charter portrayed itself as a company with "organic" or "internal" growth of subscribers; apart from its numerous acquisitions of other cable companies. The Company also touted its operating cash flow growth rate and revenue

growth. As detailed in the foregoing ¶¶ 48-82, *supra*, such statements were materially false and misleading, for the reasons summarized below:

a. Charter's internal growth rate for subscribers was artificially and materially inflated as a result of the fraudulent scheme described above.

b. But for the fraudulent subscriber scheme, the Company would not have been able to boast that it was the industry leader "in generating internal growth." Indeed, as a result of the scheme, the Company would have experienced no growth of its basic video cable subscribers during two years of the Class Period.

c. Charter also materially inflated its operating cash flow/EBITDA by: (i) improperly recognizing program launch fees at the outset of the contract rather than over the entire term of the contract; (ii) failing to write off customers and related account receivables on a timely basis; and, (iii) improperly capitalizing labor and other costs related to the servicing and termination of accounts and other general and administrative overhead expenses, that GAAP and the Company's own accounting policies required to be expensed.

d. But for such improper accounting, Charter would not have been able to boast that its operating cash flow rate was "twice that of any other cable operator." In fact, Charter's 2001 EBITDA growth rate would have been half the amount reported.

e. As a result of the foregoing schemes, Charter's reported financial results, including revenues, expenses, and operating cash flow/EBITDA, were materially

misstated throughout the Class Period, causing the price of Charter stock to be artificially inflated.

The Statements

96. Charter's Initial Public Offering commenced on November 8, 1999, and the sale to the public of the 170,00,000 shares of common stock at $19.00 per share raised approximately $3.23 billion. The November 4, 1999 Registration Statement and Prospectus represented in connection with the offering stated, among other things, that for the six months ended June 30, 1999, Charter had $594 million in revenues, with over $237 million in EBITDA. The IPO offering materials also represented that the Company was currently serving 3.7 million customers, and that an additional 2.5 million would be added through acquisitions. In its Registration Statement and Prospectus, Charter represented that its "internal customer growth" in 1998, without giving effect to the cable systems it acquired that year, "was 4.8%, more than twice the national industry average of 1.7%." The Registration Statement was signed by defendants Allen, Kent and Kalkwarf.

97. The statements regarding Charter's cash flow, customer growth rate and revenues were materially misstated for reasons set forth in ¶ 95 (a)-(e), *supra*.

98. On February 16, 2000, Charter announced its fourth quarter 1999 financial results:

> **Charter Communications, Inc. Announces Fourth Quarter Financial Results for 1999**
>
> ST. LOUIS – (BUSINESS WIRE) – Feb. 16, 2000 – Charter Communications, Inc. (Nasdaq:CHTR)

announced today financial results for the three months and the year ended December 31, 1999.

"Charter Communications ended 1999 with strong fourth quarter operating results and the company is in an excellent position to carry that momentum into 2000," said Jerald L. Kent, President and CEO of Charter. "We continued to generate *double-digit cash flow growth and once again will be among the industry leaders in internal customer growth.*" Charter reported that pro forma fourth quarter revenues and adjusted EBITDA were $763.1 million and $370.3 million, respectively, which were in line with expectations. Further, fourth quarter revenues and adjusted EBITDA grew 9.9% and 12.3%, respectively, and internal customer growth was 3.1% over the year-ago period for those cable systems owned or managed by Charter during the comparable periods.

. . . .

Revenues increased by $26.2 million or 9.9% when comparing the revenues for the three months ended December 31, 1999 to the results for the comparable systems for the three months ended December 31, 1998. This increase is due to a net gain of approximately 68,500 or 3.1% basic customers between quarters and retail rate increases implemented in certain of the Company's systems.

. . . .

The Company experienced growth in adjusted EBITDA of approximately $15.5 million or 12.3% when comparing adjusted EBITDA for the quarter ended December 31, 1999 to the results for

> the same systems for the quarter ended December 31, 1999. Adjusted EBITDA margin increased from 47.7% to 48.7% when comparing the similar periods.
>
> [Emphasis Supplied]

99. The February 16, 2000, press release was misleading for the reasons set forth in ¶ 95 (a)-(e), *supra*.

100. On March 28, 2000, Charter filed its Form 10-K for the year-end 1999 with the SEC. The Form 10-K repeated the same financial information that was announced in the press release of February 16, 2000, referenced *supra*, and was signed by defendants Allen, Kent and Kalkwarf. In its "Report of Independent Public Accountants," defendant Arthur Andersen gave the following unqualified opinion on Charter's financial statements contained in its 1999 Form 10-K:

> In our opinion, based on our audits and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Charter Communications, Inc. and subsidiaries as of December 31, 1999 and 1998, and the results of their operations and their cash flows for the year ended December 31, 1999 and for the period from December 24, 1998, through December 31, 1998, in conformity with accounting principles generally accepted in the United States.

101. This statement is false and misleading for reasons set forth in ¶ 95(a)-(e), *supra*.

102. On May 3, 2000, Charter announced first quarter 2000 results in a publicly disseminated press release:

Charter Communications, Inc. Announces First Quarter 2000 Financial Results

ST. LOUIS – (BUSINESS WIRE) – May 3, 2000 – Charter Communications, Inc. (Nasdaq:CHTR) today announced financial results for the three months ended March 31, 2000. Pro forma for the acquisition of Bresnan Communications in February 2000, revenues were $759.3 million and operating cash flow after deducting corporate overhead was $352.0 million for the first quarter of 2000 . . .

. . . .

Revenues increased by $27.2 million or 10.2% when comparing the revenues for the three months ended March 31, 2000 to the results for the comparable systems for the three months ended March 31, 1999. This increase is due to a net gain of approximately 51,900 or 2.4% basic customers between quarters and retail rate increases implemented in certain of the Company's systems.

. . . .

The Company experienced growth in operating cash flow of approximately $17.4 million or 13.7% when comparing operating cash flow for the quarter ended March 31, 2000 to the results for the same systems for the quarter ended March 31, 1999. Operating cash flow margin increased from 47.2% to 48.7% when comparing the similar periods.

103. The foregoing 1Q00 results were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

104. On May 12, 2000, Charter filed its Form 10-Q for the first quarter of 2000 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of May 3, 2000, referenced *supra*, and stated (as did each subsequent Form 10-Q issued during the Class Period) that the accompanying consolidated financial statements "have been prepared in accordance with generally accepted accounting principles . . . for interim financial information and the rules and regulations of the Securities and Exchange Commission," and "include all adjustments, which consist of only nominal recurring adjustments, necessary for a fair presentation of the results for the periods presented." The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

105. On August 2, 2000, Defendants continued to mislead investors, when announcing Charter's second quarter 2000 results in a press release:

> **Charter Communications, Inc. Announces Second Quarter 2000 Financial Results; Increases in Revenue, Operating Cash Flow, and Customers Continue**
>
> ST. LOUIS – (BUSINESS WIRE) – Aug. 2, 2000 – Charter Communications, Inc. (Nasdaq:CHTR) today reported increases in revenue, operating cash flow, and customers for the three months ended June 30, 2000.
>
> Revenue grew 9.8% to $794.8 million and operating cash flow increased 16.4% to $373.2 million for the second quarter of 2000 compared to the pro forma results for the second quarter of 1999. For those cable systems owned or managed by

> Charter during the second quarter of both 2000 and 1999, revenue and operating cash flow grew 12.8% and 15.6%, respectively, and customer growth was 2.3% over the year-ago period.

106. The foregoing 2Q00 results were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

107. On August 14, 2000, Charter filed its Form 10-Q for the second quarter of 2000 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of August 2, 2000, referenced *supra*. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

108. On November 2, 2000, Charter disseminated a press release announcing the Company's third quarter 2000 financial results. Again, the Company touted the growth in Charter's basic cable customer numbers:

> **Charter Communications Reports Continued Revenue, OCF, and Customer Growth in Third Quarter 2000 Financial Results**
>
> Aggressive Digital Video Deployment Contributes to 20% OCF Growth
>
> ST. LOUIS – (BUSINESS WIRE) – Nov. 2, 2000 – Charter Communications, Inc. (Nasdaq:CHTR) today reported continued growth in revenues, operating cash flow (OCF), and basic, digital and data customers for the three months ended September 30, 2000, compared to pro forma year-ago results.

Third Quarter Highlights

Pro forma revenues increased 13.9% to $842.9 million and pro forma operating cash flow increased 20.2% to $400.6 million for the third quarter of 2000 compared to the pro forma results for the third quarter of 1999. Charter added over 55,000 basic cable customers during the third quarter, contributing to a year-to-year increase of approximately 2.3% compared to the pro forma customer level of 6,178,800 at September 30, 1999. . . .

For "same-store" cable systems owned by Charter during the third quarter of both 2000 and 1999, revenues and system operating cash flow grew 12.8% and 19.5%, respectively. These systems represented 2,671,000 customers at September 30, 2000, reflecting a 2.3% growth rate in basic customers compared to a year ago.

109. The foregoing 3Q00 results were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

110. On November 13, 2000, Charter filed its Form 10-Q for the third quarter of 2000 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of November 2, 2000, referenced *supra*. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

111. On February 15, 2001, Charter continued to mislead investors when announcing its 2000 year-end results in the following press release:

Charter Communications Reports Continued Revenue, OCF, and Customer Growth in Fourth Quarter 2000 Financial Results

Aggressive Digital and High-Speed Data Deployment to Drive 2001 Growth

ST. LOUIS – (BUSINESS WIRE) – Feb. 15, 2001 – Charter Communications, Inc. (Nasdaq:CHTR) today reported continued acceleration in the growth of revenues, operating cash flow (OCF), and basic, digital and data customers for the three months ended December 31, 2000, compared to pro forma year-ago results and compared to all other quarters in 2000.

2000 Financial Highlights

Jerry Kent, President and CEO, said "I'm pleased to report that we met, or in most cases significantly exceeded, all of the goals we set at the start of the year, *as well as those expected by Wall Street analysts*. In the fourth quarter, we capped the year with OCF growth that is almost twice that of any other major cable operator. We saw *acceleration in core basic customer growth*, which indicates the success of our digital strategy. And we ended the year with advanced service deployments that exceeded our original optimistic expectations. . . ."

For the fourth quarter of 2000, revenues increased 15.8% to $893.9 million, and OCF increased 28.9% to $433.2 million compared to the pro forma results for the fourth quarter of 1999. Pro forma revenues and OCF for the year 2000 increased 11.9% to $3.30 billion and 19.0% to $1.56 billion, respectively, compared to pro forma 1999 annual results. Pro forma internal customer growth was 2.5% for the year 2000. "*We*

apparently retained our industry leadership in generating internal customer growth," Mr. Kent said. "Our aggressive approach to competition has enabled us to accelerate our internal customer growth throughout the year," he continued. At December 31, 2000, Charter served 6,350,900 basic cable customers, compared to 6,193,700 pro forma as of December 31, 1999, a pro forma net gain of 157,200 customers.

For "same-store" cable systems owned by Charter during the fourth quarter of both the years 2000 and 1999, revenues and system operating cash flow grew 18.3% and 28.9%, respectively. These systems represented 3,783,600 customers at December 31, 2000, reflecting a 2.2% internal growth rate in basic customers compared to a year ago.

[Emphasis Supplied].

112. The foregoing 4Q00 and year end 2000 results were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*. In addition, the foregoing results were materially inflated as a result of Charter's sham transactions with Scientific-Atlanta and Motorola by which Charter agreed to pay additional monies for goods, in return for these vendors paying Charter advertising fees.

113. On February 28, 2001, Charter filed its Form 10-K for the year-end 2000 with the SEC. The Form 10-K repeated the same financial information that was announced in the press release of February 15, 2001, referenced *supra*, and was signed by defendants Allen, Kent and Kalkwarf. Charter's Form 10-K for the year ended 2000 was materially false and misleading. In its "Report of Independent Public Accountants," defendant Arthur

Andersen gave the following unqualified opinion on Charter's financial statements contained in its 2000 Form 10-K:

> In our opinion, based on our audits and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Charter Communications, Inc. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations and their cash flows for the years then ended, and for, the period from December 24, 1998, through December 31, 1998, in conformity with accounting principles generally accepted in the United States.

114. On May 2, 2001, Charter announced its first quarter 2001 results in the following press release:

> **Charter Communications Announces Solid First Quarter Results; Digital Video and High-Speed Data Deployments Exceed Expectations**
>
> ST. LOUIS – (BUSINESS WIRE) – May 2, 2001 – Charter Communications, Inc. (Nasdaq:CHTR) today reported revenue and operating cash flow growth at the high end of previously stated guidance for the first quarter of 2001 . . .
>
> First Quarter Financial Highlights
>
> For the first quarter of 2001 revenues increased 14.4% to $873.8 million, and operating cash flow (OCF) increased 9.7% to $387.9 million compared to the pro forma results for the first quarter of 2000. Charter increased its customer base by over 2.0% compared to pro forma first quarter of 2000 to 6,349,800 customers. "We continue to deliver by increasing revenue and OCF through

internal and advanced broadband services customer growth made possible by our digital platform," Mr. Kent said.

115. In a conference call with analysts following the release of its quarterly results, senior Charter officers expressed confidence that its annual basic customer growth would exceed 2%, indicating an acceleration throughout the balance of the year. The Company attributed this increase in growth, in part, to "decreasing churn," i.e. decreasing loss of existing customers. (See UBS Warburg; ABN AMRO, 5/3/01).

116. The foregoing 1Q01 results and statements in the conference call were materially false, misleading and without reasonable basis for the reasons set forth in ¶ 95(a)-(e), *supra*.

117. On May 15, 2001, Charter filed its Form 10-Q for the first quarter of 2001 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of May 2, 2001, referenced *supra*. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

118. Indicative of the degree to which analysts were beguiled by Charter's fraudulent image, Credit Suisse First Boston resumed coverage of the Company on June 4, 2001 with a "Strong Buy" recommendation based on Charter's perceived subscriber growth rate that was "twice industry average," attributable to "falling churn, better customer service and more sophisticated settling techniques." On June 5, 2001, Deutsche Bank issued a report projecting pro forma EBITDA growth at 14-16% for the year. Recommendations such as these, which were based

on defendants' fraudulent representations and guidance to analysts, propelled Charter's stock price to over $22 per share.

119. On July 30, 2001, Charter continued to mislead investors when the Company announced its second quarter 2001 results in the following press release, which states in part:

> **Charter Communications Exceeds Revenue, Operating Cash Flow Guidance; Strong Digital Video, High-Speed Data and Basic Customer Increases Continued During Second Quarter**
>
> ST. LOUIS – (BUSINESS WIRE) – July 30, 2001 – Charter Communications, Inc. (Nasdaq:CHTR) today reported second quarter 2001 revenue and operating cash flow growth exceeding Wall Street estimates. Increases in digital video, high-speed data, and basic video customers during the three-month period ended June 30, 2001 were in line with the company's previously stated guidance, according to Jerry Kent, President and CEO.
>
> Second Quarter Financial Highlights
>
> For the second quarter of 2001, revenue increased 16.1% to $928.5 million, and operating cash flow increased 14.1% to $428.1 million compared to pro forma results for the second quarter of 2000. This compares favorably to previous guidance of 13%-15% revenue growth and 11.5%-13.5% operating cash flow growth for the second quarter. Charter reported internal customer growth of 2.1% compared to pro forma second quarter of 2000 for a total of 6,388,300 customers
>
> . . . .

120. A conference call after the release of these results reinforced the upbeat, albeit false, impression provided analysts. As Richard Bilotti from Morgan Stanley Dean Witter commented in a report issued at the time, "The most important takeaway from the quarter and the call with management is the company's strong belief in the sustainability of these growth rates."

121. The foregoing 2Q01 results and statements to analyst were materially false, misleading and without reasonable basis for the reasons set forth in ¶ 95(a)-(e), *supra*.

122. On August 13, 2001, Charter filed its Form 10-Q for the second quarter of 2001 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of July 30, 2001. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

123. On September 11, 2001, Charter announced preliminary third quarter 2001 results:

> **Charter Communications Expects Accelerated Growth in Third Quarter 2001 Advanced Services; Company Will Shift Focus From Basic Customer Growth to Advanced Services**
>
> PASADENA, Calif. – (BUSINESS WIRE) – Sept. 11, 2001 – Charter Communications, Inc. (Nasdaq: CHTR) said today that based on third quarter digital and high-speed data sales to date, it expects third quarter 2001 advanced services additions to exceed those of second quarter 2001. Charter President and CEO Jerry Kent said the

Company expects to meet or exceed the high end of guidance for year-end digital and high-speed data customers.

. . . . Mr. Kent said Charter has made a strategic decision to focus more of its marketing expenditures and management time on advanced service growth. "We've reviewed our internal marketing plans, management focus and current operating results in light of the current economic environment, and believe that a rebalancing of emphasis to digital and data sales at the expense of marginal increases in basic customer growth is the right business decision. Our number one priority now is to increase digital and data customers which provide higher profitability and competitive advantage."

Mr. Kent said he expects Charter's basic customer growth for 2001 to be less than the original guidance of at least 2 percent as a result of this refocus. "We'll remain mindful of the ongoing need for internal basic customer growth, and I'm confident Charter will continue to lead the industry as we have for the past five years."

"As advanced services are deployed to a rapidly growing number of customers, operating cash flow growth accelerates," Mr. Kent said. "Pro forma operating cash flow growth for the first half of 2001 was 11.1 percent. Despite the slowdown in economic conditions, this growth rate is expected to accelerate for the remainder of the year."

[Emphasis Supplied.]

124. The foregoing statements were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

125. While the foregoing representations were false and misleading, they were the first signal of a decline in Charter's customer growth rate. Indicative of the stock price inflation that had resulted from Charter's reports and projections of customer growth rates which had been bloated by the "hold disconnects" practice and other devices described above, this first disclosure triggered a 20% decline in the price of the Company's stock price, from a close of $20.04 on September 7, 2001, to a close of $16.00 on September 21, 2001, at 2-3 times the normal trading volume.

126. Further indicative of the emphasis that defendant Allen had placed on customer growth rate, following this reported decline in rate, defendant Kent was ousted as the Company's President and CEO. This was announced on September 24, 2001. News reports attributed Kent's departure to undisclosed disagreements and personality conflicts with defendant Allen.

127. This news further unsettled investors, who further bailed out of the Company, resulting in a decline in the price of Charter's stock to $12.00 per share on September 27, 2001. Consistent with the concerns raised by these events, Goldman Sachs reduced its EBITDA estimates for 2001, citing the "slower sub growth rate." (10/9/01)

128. On October 9, 2001, Charter named defendant Vogel as the Company's new President and CEO.

129. On November 1, 2001, defendants announced Charter's final third quarter 2001 results in a press release, which stated in part:

> **Charter Communications Reports Strong Third Quarter Advanced Services Growth**
>
> Company Continues to Pace the Industry with Internal Customer Growth
>
> ST. LOUIS B Charter Communications, Inc. (Nasdaq: CHTR) today reported double digit revenue and operating cash flow growth for the third quarter of 2001 resulting from continued consumer demand for broadband services. These results were highlighted by the addition of a record number of new cable modem customers during the third quarter.
>
> . . . .
>
> Third Quarter Financial Highlights
>
> For the third quarter of 2001, revenue increased more than 13% to $1.04 billion, and operating cash flow increased more than 10% to $467.5 million compared to pro forma results for the third quarter of 2000. Charter continued to pace the industry with internal customer growth of 1.1% compared to pro forma third quarter of 2000 for a total of 6,970,100 customers. "Basic customer growth has slowed after a planned reduction in discounting and basic service marketing efforts, part of a previously announced strategic shift of focus to advanced services that will better enhance operating cash flow growth. This focus is starting to pay off, as evidenced by our impressive advanced services growth. I'm especially proud of the men and women of Charter for their

perseverance in these challenging times," Mr. Vogel said.

130. The foregoing 3Q01 results were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

131. On November 14, 2001, Charter filed its Form 10-Q for the third quarter of 2001 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of November 1, 2001, referenced *supra*. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

132. Investors became increasingly skeptical about Charter following the departure of defendant Kent, and particularly as concerns surfaced about the nature of its previously reported significant customer growth rates. In late 2001, the market began learning that Charter had engaged in a "practice of aggressively driving basic subscriber growth over the last two years" which had purportedly enabled the Company to increase its subscriber "base roughly twice as fast as its peers in 1999, 2000, and through much of 2001" (See October 4, 2002 Bank of America Securities report). As the Company began acknowledging that its growth rates were slowing, even some analysts became more cautious about the Company (still unaware that the prior growth rate was not simply the result of aggressiveness, but of covert manipulation of the figures).

133. Thus, on January 10, 2002, Morgan Stanley analyst Richard Bilotti reduced his rating from "Strong Buy" to "Outperform," citing slowing EBITDA growth, which, now at 10%, was "about 100-200 basis points below

the industry average." This came on the heels of the Company's acknowledgment on November 1, 2001, that its subscriber growth rate, which had been at 2.3% a year prior, had declined to 1.1% in the most recent quarter. These concerns caused the market price of Charter stock, which had been over $16 per share at the beginning of 2002, to plummet over 20% to $13 per share by January 18, 2002. (These growth rates, while reduced, were still artificially buoyed by Charter's "hold disconnects" practices detailed in ¶¶ 49 to 59, *supra*.)

134. On February 11, 2002, Charter continued to mislead investors when it announced its 2001 year-end results in a press release, which stated in part:

> **Charter 2001 Pro Forma Cable Modem and Digital Customers Increase Nearly 165% and 82%, Respectively**
>
> ST. LOUIS – Charter Communications, Inc. (Nasdaq: CHTR) today reported revenue growth that exceeded its guidance, and cash flow growth at the top of its estimated range for the year 2001. These results were highlighted by the addition of a near record number of new cable modem customers during the fourth quarter.
>
> . . . .
>
> As of December 31, 2001, Charter Digital Cable™ customers totaled 2,144,800 with fourth quarter weekly additions averaging approximately 15,000 installations per week. "Charter continues to experience strong demand for its digital video service, resulting in industry leading penetration. As we continue to add interactive products like video on demand (VOD), and personal interactive channels, we see enhanced

> customer satisfaction, reduced digital churn, and improved retention levels," Mr. Vogel said.
>
> . . . .
>
> Fourth Quarter Financial Highlights
>
> Revenue during the fourth quarter of 2001 increased 13.6% to $1.1 billion, and operating cash flow increased 11.0% to $502.6 million compared to pro forma results for the fourth quarter of 2000, before a special charge including the @Home conversion of $17.6 million. Year-end 2001 pro forma revenue was over $4.1 billion, up 14.0% from pro forma 2000 revenue of $3.6 billion. Pro forma operating cash flow increased 10.9% from $1.65 billion to $1.83 billion for 2001, before a special charge including the @Home conversion of $17.6 million.

135. In connection with the announcement of these year-end results, Charter hinted for the first time that its customer base had been materially inflated. However, it did so in a misleading manner so as to avoid any critical examination of its prior representations. The Company stated that it expected to remove approximately 120,000 "marginal customers" from its basic customer account in the first quarter of 2002, and that it had increased its reserves for uncollected accounts receivable as of December 31, 2001. This write-off represented two years of the company's basic customer subscriber growth.

136. The foregoing 4Q01 results were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*. In addition:

a. The reasons given for the write-off of customers was false and misleading. The Company sought to give

the impression that it was taking an initiative to make its customer base even stronger by eliminating those that may have paid their bills, but were "marginal" and thus not profitable. Indeed, as an analyst at Banc of America Securities characterized it, Charter had merely decided to "disconnect unprofitable subscribers." (April 29, 2002 report.)

b. In fact, the Company was now doing what it should have done long before, i.e., write-off customers who had themselves sought to terminate their accounts. The statement was designed and intended to deflect attention from the fact that Charter's internal customer growth rate had been materially smaller than represented. In fact, the write-off of these customers was needed because the Company had been holding disconnects of well over 100,000 customers cumulatively during the Class Period.

c. Moreover, the Company failed to disclose the full extent of its potential write-off. At the same time Charter wrote-off 120,000 customers, it created a "reserve" for disconnecting 45,000 additional customers.

137. On March 29, 2002, Charter filed its Form 10-K for the year-end 2001 with the SEC. The Form 10-K repeated the same financial information that was announced in the press release of February 11, 2002, referenced *supra*, and was signed by defendants Allen, Vogel and Kalkwarf. The Company raised the number of customers written off to 145,000 (from the previously announced 120,000). It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

138. In its "Report of Independent Public Accountants," defendant Arthur Andersen gave the following

unqualified opinion on Charter's financial statements contained in its 2001 For 10-K:

> In our opinion, based on our audits and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Charter Communications, Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

139. This was false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

140. Defendants continued to mislead investors in a press release dated April 29, 2002;

> **Charter Posts Strong Revenue and Cash Flow Growth For the First Quarter of 2002**
>
> Strategic marketing and bundling of services drives first quarter 2002 revenue and operating cash flow growth
>
> ST. LOUIS – Charter Communications, Inc. (Nasdaq: CHTR) exceeded expectations for revenue and cash flow growth during the first quarter of 2002.
>
> First Quarter Financial Highlights
>
> Revenue during the first quarter of 2002 increased 13.1% to $1.1 billion, and operating cash flow increased 10.4% to $449.2 million compared to pro forma results for the first quarter of 2001. "Our revenue and cash flow for the quarter exceeded the high end of our expectations and will

> provide a solid base of growth which we expect to accelerate throughout the year," Mr. Vogel said. Charter reported basic and diluted loss per share of $39 for the first quarter of 2002, compared to a loss per share of $1.20 for the first quarter of 2001.

141. The foregoing 1Q02 results were materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

142. By this time though, even upbeat analysts were beginning to acknowledge that the decline in the Company's stock price (to a closing price of $7.79 per share on May 13, 2002), was attributable to growing investor skepticism triggered by the February write-off of customers. As a Credit Suisse analyst commented in a report dated May 14, 2002:

> The Company recently announced it would have to write down 120,000 basic video subscribers due to nonpayment, which represent 2 years of subscriber growth and a significant credibility issue with investors.

143. On May 14, 2002, Charter filed its Form 10-Q for the first quarter of 2002 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of April 29, 2002, referenced *supra*. The Form 10-Q was signed by defendants Kalkwarf and Martin. It was materially false and misleading for the reasons set forth in ¶ 95(a)-(e), *supra*.

144. The market price of Charter stock continued to descend as investors, aware of the unraveling fraud at Adelphia, were concerned that the same thing might have occurred at Charter as well. By June 13, 2002, Charter's

stock price had sunk to $4.48 per share. At this point, one of the company's boosters, Morgan Stanley, came to the Company's defense in an analyst report dated June 14, 2002, seeking to assure investors that Charter was not another Adelphia. The report was written after further communication with Charter management, including defendants Barford and Kalkwarf:

> We believe that Charter does not represent a risk for accounting inconsistencies or revisions to prior financial performance. Since its public offering in late 1999, Charter has remained consistent with respect to how it recognizes revenue, capitalizes labor, and depreciates its network. We believe that the panic selling that has occurred over the last few months as the Adelphia situation has unraveled, represents a buying opportunity . . . .
>
> We estimate that Charter capitalizes about $325-350 million of installation and engineering labor costs each year. These estimates are within the range for the group, but not at the lower end of the range for the industry . . . *It is very important to recognize that Charter has consistently applied its capitalization policies and has not made accounting changes that might have distorted revenue and EBITDA growth rates.*
>
> [Emphasis Supplied].

145. The foregoing statements by Morgan Stanley, which helped boost the price of Charter stock by over 20% in one day, were indicative of the degree to which defendants had misled investors, since, contrary to the analyst's conclusions, Charter had indeed consistently capitalized labor charges that it knew, even under its own policies, should have been expensed.

Revelations

146. On July 18, 2002, one day after the end of the Class Period, Merrill Lynch published a Comment concerning Charter by analyst Jessica Reif Cohen ("Cohen") entitled "Q2E: Basic Sub Losses Continue and Accounting Worries Not Over; Downgrade to Neutral;"

> We are reducing our intermediate term investment rating to Neutral from Strong Buy due to Charter's high leverage, lack of positive free cash flow generating for at least 18 months and continued accounting worries in general for the sector. Additionally, investors remain averse to highly leveraged companies with no earnings and no free cash flow, i.e. companies with EBITDA-based valuations.
>
> . . . .
>
> Accounting Practices
>
> We believe that Charter's upcoming June 10Q filing will include more detail about its accounting practices, including subscriber count calculations and marketing deals with equipment vendors. Further, Charter plans to offer more clarity in its capital expenditures and debt covenants. While we applaud Charter's decision, the release of more detail could be a double-edged sword. While investors are likely to appreciate the more detailed filing, since they have been clamoring for more transparency, investors might not be reassured by what they uncover.
>
> While accounting practices are relatively similar across the industry, there are some differences across cable operators. We believe that Charter has a more aggressive capitalization policy, evidenced by its top-of-the-industry EBITDA

> margins and also its high capex spending per basic subscriber (although some of that is partially due to Charter's lower densities). Further Charter includes some of its programming launch fees in cable advertising revenue (similar to AOL but unlike Cox, Comcast and Cablevision). This is actually significant and consisted of roughly one third ($100 million) of total CY01 advertising revenue at essentially 100% EBITDA margins. In addition, we understand that Charter allocates the $10/month incremental revenue from its data-only subscribers (data-only subs. are typically charged an additional $10 for not taking a bundle of data+video) to basic cable revenue and hence includes the subscriber in the basic cable subscriber count. While we believe this is a very insignificant number, the mere fact that Charter is taking such an aggressive stance could lead investors to question all its practices. Moreover, we understand that Charter has done some marketing deals with equipment vendors (as does Comcast).

147. The partial disclosure of Charter's improper accounting practices, as described in Cohen's July 18, 2002 Comment, had an immediate and sharply negative effect on Charter's stock price. On that day, Charter's stock dropped more than thirteen percent (13%), falling from the previous day's close of $4.06 per share, to close of $3.50 per share on July 19, 2002.

148. Indeed, Charter's use of misleading accounting practices to artificially inflate its revenue and earnings was further detailed in the August 12, 2002, issue of *Forbes*, which quoted a July 12, 2002, report by Credit Suisse First Boston concerning the cable industry. The *Forbes* article stated in pertinent part:

> The [Credit Suisse] report provides a detailed look at "churn," which is essentially cable's costs for labor and advertising. Credit Suisse says that cable companies have been hiding the impact of their churn by capitalizing labor costs. In other words, if they spend $50 to install cable in a home, the cable guys only subtract $20 from revenues to calculate the current period's earnings. Then they spread the rest over a dozen years. The worst offender, Credit Suisse says, is Charter Communications, which capitalizes $29 per customer.

149. On August 16, 2002, Charter acknowledged that it had received a subpoena for documents from a federal grand jury that was conducting a criminal investigation of "the Company's current and disconnected customers, and its policies and procedures related to the capitalization or expense of various costs and related matters." The Company further admitted that the investigation probably related in part to the matters raised by the CSFB and Merrill Lynch analyst reports. The investigation also followed on the heels of the Company's announcement that it was increasing its reserves to account for its decision to disconnect 145,000 "marginal" customers.

150. On October 22, 2002, Charter announced that it was placing its COO, defendant Barford, on paid leave, pending the previously announced Grand Jury investigation.

151. On December 3, 2002, the Company announced that defendant William Shreffler, who was then Senior Vice President of Operations for the Midwest Division, resigned his position, "citing personal reasons."

152. On December 23, 2002, Charter announced that it was firing defendants Barford and Kalkwarf, and reauditing its books for 2000 and 2001. "The terminations of Messrs. Barford and Kalkwarf follow a review by the Company of various matters, including those related to the Grand Jury investigation," a Company spokesman said.

153. As a result of these revelations, Charter's shares dropped to a 52-week low of $0.78 on October 11, 2002, down approximately 97% from its Class Period high of $26.31.

154. On April 1, 2003, Charter announced the "preliminary results" of the reaudit for years 2000 and 2001. As a result of the reaudit, the following major restatements were made:

	2001 ($ millions)	2000 ($ millions)
Revenue Reduced by:	$146	$108
Expenses Increased by:	$146	$87
EBITDA Reduced by:	$292	$195

155. The Company acknowledged that as a result of the foregoing, its pro forma adjusted EBITDA for 2001, which had previously been reported as $1.8 billion, was restated to only $1.543 billion. Similarly, whereas reported pro forma adjusted EBITDA for 2000 had been previously reported as $1.6 billion, it was restated to only $1.454 billion. Thus, in contrast to the previously reported EBITDA growth rate between 2001 and 2000 of 12.5%, the actual growth rate was only 6%.

156. There were further materially adverse adjustments announced for the first 3 quarters of 2002, though

there was no indication of the portion of those adjustments that related only to the first quarter of 2002.

157. The April 1, 2003 press release also stated:

> **(a) Launch Incentives From Programmers.**
>
> Amounts previously recognized as advertising revenue in connection with the launch of new programming channels have been deferred in the year such launch support was provided, and amortized as a reduction of programming costs based upon the relevant contract term. Such adjustments decreased revenue $30 million for the first three quarters of 2002, and $118 million and $76 million for the years ending December 31, 2001 and 2000, respectively. Additionally, for the year ending December 31, 2000, the company increased marketing expense by $24 million for other promotional activities associated with launching new programming services previously deferred and subsequently amortized. The corresponding amortization of such deferred revenues reduced programming expenses by $36 million for the first three quarters of 2002, and $27 million and $5 million for the years ending December 31, 2001 and 2000, respectively.
>
> **(b) Capitalized Labor and Overhead Costs.**
>
> Certain elements of labor costs and related overhead allocations previously capitalized as part of the Company's rebuild activities, customer installation and new service introductions have been expensed in the period incurred. Such adjustments increased operating expenses by $73 million for the first three quarters of 2002, and $93 million and $52 million for the years ending December 31, 2001 and 2000, respectively.

(c) **Customer Acquisition Costs.**

Certain customer acquisition campaigns were conducted through third party contractors in 2000, 2001 and portions of 2002. The costs of these campaigns were originally deferred and recognized as amortization expense over the relevant customer contract terms. These amounts have been reported as marketing expense in the period incurred and totaled $32 million for the first three quarters of 2002, and $59 million and $4 million and for the years ending December 31, 2001 and 2000, respectively. The company determined in the second quarter of 2002 that the benefits of this program did not justify its continued practice and it was eliminated in the end of the third quarter as contracts for third party vendors expired.

158. In response to these disclosures, Deutsche Bank Securities, Inc., issued analyst reports noting that Charter's "adjustments" of $487 million to previously reported EBITDA represented "*significant* reductions relative to the restated pro forma totals. . . ." [Emphasis Supplied]. A. G. Edwards issued a similar report stating "we believe that the breadth of these restatements are significant. . . ."

159. The Company also disclosed for the first time that there had been "45,000 accounts that were reserved at year end 2001 to address pending disconnects." This was in addition to the 120,000 customers the Company had announced it would be writing off at the time. (In fact, the Company wrote-off an additional 25,000 customers by July 2002, and had no "reserve" for customer disconnects at year end 2002.)

160. With respect to the ongoing Grand Jury investigation, Charter stated:

> The adequacy of the 45,000 customer reserve, the disconnect policies, the application of those policies and their effect on the customer totals reported by the Company during 2001 and prior periods are currently under investigation by the United States Attorney's Office for the Eastern District of Missouri and the Securities and Exchange Commission.

161. Finally, the Company acknowledged that these restated results were "preliminary" and that it had filed for an extension "to provide additional time to finalize its financial statements, related filings, disclosures and audits."

The Indictment and Guilty Plea

162. On July 24, 2003, the Grand Jury returned an Indictment charging that:

> Beginning in or about May 2001 and continuing through in or about March 2002, Barford, Kalkwarf, McCall and Smith knowingly devised and intended to devise a scheme to defraud investors in Charter securities and the investing public . . . by falsely inflating Charter's subscriber numbers and subscriber growth numbers and by making false statements relating to Charter's subscriber numbers and subscriber growth numbers, in order to inflate artificially Charter's stock price . . . . (Indictment ¶ 44).

163. The Indictment further charged that:

> Beginning in or about August 2000, and continuing through on or about February 11, 2001, Kalkwarf and Barford knowingly devised and intended to devise a scheme to defraud investors in

> Charter securities . . . by falsely inflating Charter's publicly reported year end revenue and operating cash flow and by making false statements relating to the inflated revenue and operating cash flow, in order to inflate artificially Charters' stock price. . . . (Indictment ¶ 17).

164. In his guilty plea entered the next day, on July 25, 2003, defendant McCall admitted that:

> From in or about June of 2001 and continuing until in or about March of 2002 . . . David McCall did knowingly and willfully participate in a scheme to defraud Charter's stockholders by means of materially false and fraudulent pretenses, presentations and promises. (Guilty Plea at 9)

165. That same day, at a hearing before the Honorable Carol Jackson, defendant McCall stated:

> I was instructed to meet certain quarterly expectations, in terms of company expectations for how many customers you gained on a quarterly basis. Did that. And instructed people that worked for me to do that and knowing that, you know, that those numbers would in turn be used to meet forecasts that would be done in a public – to the public environment like Wall Street. (Transcript at 16-17)

CLASS ACTION ALLEGATIONS

166. Lead Plaintiff brings this action as a class action pursuant to Rules 23(a) and 23(b)(3) of the Federal Rules of Civil Procedure, individually and on behalf of all persons or entities who purchased or acquired Charter common stock during the Class Period and were damaged

thereby, excluding the Defendants herein, their affiliates and any officers or directors of Charter or its affiliates, and any members of their immediate families and their heirs, successors and assigns (the Class).

167. The Class is so numerous that joinder of all the members of the Class is impracticable. Lead Plaintiff believes there are hundreds of record holders of the Company's common stock located throughout the United States.

168. Lead Plaintiff's claims are typical of the claims of absent Class members. Members of the Class have sustained damages arising out of Defendants' wrongful conduct in violation of the federal securities laws in the same way as Plaintiff sustained damages from the unlawful conduct.

169. Lead Plaintiff will fairly and adequately protect the interests of the Class. Lead Plaintiff has retained counsel competent and experienced in class action and securities litigation.

170. A class action is superior to other available methods for the fair and efficient adjudication of the controversy. The Class is numerous and geographically dispersed. It would be impracticable for each member of the Class to bring a separate action. The individual damages of any member of the Class may be relatively small when measured against the potential costs of bringing this action, and thus make the expense and burden of this litigation unjustifiable for individual actions. In this class action, the Court can determine the rights of all members of the Class with judicial economy. Lead Plaintiff does not anticipate any difficulty in the management of this suit as a class action.

171. Common questions of law and fact exist as to all members of the Class and pre-dominate over any questions affecting solely individual members of the Class. These questions include, but are not limited to, the following:

a. whether defendants' conduct as alleged herein violated the federal securities laws;

b. whether the SEC filings, press releases and statements disseminated to the investing public during the Class Period misrepresented Charter's financial condition and results;

c. whether defendants acted knowingly or with deliberate recklessness in omitting and/or misrepresenting material facts;

d. whether the market price of Charter common stock during the Class Period was artificially inflated; and

e. whether the members of the Class have been damaged, and if so, what is the proper measure of damages.

172. Lead Plaintiff will rely, in part, upon the presumption of reliance established by the fraud-on-the-market doctrine in that:

a. defendants made public misrepresentations or failed to disclose material facts during the Class Period;

b. the omissions and misrepresentations were material;

c. the stock of the Company traded on the Nasdaq, an efficient market;

d. the market reacted to public information disseminated by the Company, and the Company was followed and reported on by various securities analysts;

e. the misrepresentations alleged would tend to induce a reasonable investor to misjudge the value of the Company's securities; and,

f. Lead Plaintiff and the members of the Class purchased their Company stock between the time the defendants or misrepresented material facts and the time the true facts were disclosed, without knowledge of the misrepresented facts.

COUNT I

VIOLATIONS OF §§ 11, 12 and 15 OF THE SECURITIES ACT AGAINST ALL CHARTER RELATED DEFENDANTS OTHER THAN VOGEL

173. Lead Plaintiff repeats and re-alleges, as if fully set forth herein, those paragraphs regarding the initial public offering of Charter stock; the false and misleading statements made in connection therewith; and the reasons why those statements were false and misleading, *i.e.*, ¶¶ 95-97, *supra*. This claim does not sound in fraud, and neither fraud nor scienter is an element of this claim. None of the paragraphs regarding defendants' scienter are incorporated herein.

174. This claim is brought by Lead Plaintiff on behalf of all persons who purchased shares of Charter stock pursuant to the IPO Registration Statement Lead Plaintiff and other Class members acquired their shares pursuant to or traceable to the Registration Statement.

175. Defendants (other than Vogel, Scientific-Atlanta and Arthur Andersen) issued and disseminated, caused to be issued and disseminated, and participated in the issuance and dissemination of, materially false and misleading written statements to the investing public which were contained in the Registration Statement, which misrepresented or failed to disclose, *inter alia*, the facts set forth above in ¶ 95(a)-(e), *supra*. Charter issued the Prospectus and Registration Statement that accompanied the IPO. Each of the Individual Defendants (other than Vogel) was an officer, director, or controlling person of Charter at the time of the IPO.

176. As a direct and proximate result of defendants' acts and omissions in violation of the Securities Act, the market price of Charter stock was artificially inflated in the IPO, and Lead Plaintiff and the Class suffered substantial damage in connection with their purchase of Charter common stock pursuant to the Registration Statement and Prospectus.

177. At the times they purchased their shares in the IPO, Lead Plaintiff and members of the Class who purchased such shares were without knowledge of the facts concerning the false or misleading statements or omissions alleged herein.

178. Less than two years elapsed from the time that the events upon which this action is based, to the time that this action was filed. Less than five years elapsed from the time that the securities upon which this claim is brought were offered to the public to the time this action was commenced.

COUNT II

VIOLATIONS OF § 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 PROMULGATED THEREUNDER AGAINST ALL CHARTER RELATED DEFENDANTS

179. Lead Plaintiff repeats and realleges each and every allegation contained in the paragraphs above as if fully set forth herein.

180. At all relevant times, the Charter Related Defendants, individually and in concert, directly and indirectly, by the use and means of instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct whereby they knowingly and/or with deliberate recklessness made and/or failed to correct public representations which were or had become materially false and misleading regarding Charter's financial results and operations as set forth in ¶¶ 96-136, *supra*. These statements were materially false and misleading for reasons stated in ¶ 95(a)-(e), *supra*.

181. Defendant Charter was a direct participant in the wrongs complained of herein. The Individual Defendants are liable for the wrongs complained of herein as direct participants in and controlling persons of the Company. By virtue of their positions of control and authority as officers, directors and controlling shareholder of Charter, the Individual Defendants were able to and did, directly or indirectly, control the preparation, issuance and/or content of the aforesaid public statements relating to the Company. Portrait photographs of each of the Individual Defendants were included in Charter's 2000 or 2001 Annual Reports. Each of the Individual Defendants participated in making the false and misleading statements under the group publication doctrine.

182. The Charter Related Defendants had actual knowledge of the facts making the material, statements false and misleading, or deliberately acted with reckless disregard for the truth in that they failed to ascertain and to disclose such facts, even though same were available to them as set forth in ¶¶ 83-94, *supra*. In addition:

a. As officers, directors and/or controlling persons of a publicly held company whose common stock is registered with the SEC under the Exchange Act and traded on the Nasdaq, the Individual Defendants had a duty to promptly disseminate accurate and truthful information with respect to the Company's operations, finances, financial conditions, and present and future business prospects, to correct any previously issued statement from any source that had become untrue, and to disclose any trends that would materially affect earnings and the present and future operating results of Charter, so that the market price of the Company's publicly traded securities would be based upon truthful and accurate information.

b. During the Class Period, the Individual Defendants were senior executives and directors of Charter and were privy to confidential and proprietary information concerning Charter, its operations, finances, financial condition, products, and present and future business prospects via internal corporate documents, conversations and connections with other corporate officers and employees, attendance at management and Board of Directors meetings and committees thereof, and via reports and other information provided to them in connection therewith.

183. In ignorance of the adverse facts concerning Charter's business operations and earnings, and in reliance on the integrity of the market, Lead Plaintiff and the members of the Class acquired Charter common stock at artificially inflated prices and were damaged thereby.

184. Had Lead Plaintiff and the members of the Class known of the materially adverse information not disclosed by the Charter Related Defendants, they would not have purchased Charter common stock at all, or not at the inflated prices paid.

185. By virtue of the foregoing, the Charter Related Defendants have violated Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

COUNT III

VIOLATION OF § 20(a) OF THE EXCHANGE ACT AGAINST THE INDIVIDUAL DEFENDANTS

186. Lead Plaintiff repeats and realleges each and every allegation contained in the paragraphs above as if fully set forth herein.

187. This count is asserted against the Individual Defendants and is based upon Section 20(a) of the 1934 Act.

188. The Individual Defendants, by virtue of their offices, directorships, stock ownership and specific acts were, at the time of the wrongs alleged herein and as set forth in Count II, controlling persons of Charter within the meaning of Section 20(a) of the 1934 Act. The Individual Defendants had the power and influence and exercised the same to cause Charter to engage in the illegal conduct and

practices complained of herein by causing the Company to disseminate the false and misleading information referred to above. Moreover, during the Class Period, the defendant Allen controlled a majority of the Company's stock.

189. By virtue of the conduct alleged in Count II, the Individual Defendants are liable for the aforesaid wrongful conduct and are liable to Lead Plaintiff and the Class for damages suffered.

COUNT IV

VIOLATIONS OF § 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 PROMULGATED THEREUNDER AGAINST ARTHUR ANDERSEN

190. Lead Plaintiff incorporates by reference all of the foregoing paragraphs as if realleged herein.

191. Defendant Arthur Andersen served as Charter's independent auditors throughout the Class Period. In that capacity, it performed audits of Charter's books, records, and financial statements for the years 1999, 2000, and 2001. Following such audits, Arthur Andersen issued opinion letters stating that its audits of Charter's financial statements had been conducted in conformance with Generally Accepted Auditing Standards, and that statements conformed with GAAP.

192. Such statements were false and misleading, for reasons set forth in ¶ 95(a)-(e), *supra*. As set forth in ¶¶ 153-157, *supra*, annual reports for 2000 and 2001 have been restated.

193. As Charter's auditor, Arthur Andersen had full access to its books, records and personnel, and knew, or recklessly disregarded, *inter alia*, the facts that:

a. The Company's capitalization rate was the highest in the industry, and resulted from the Company's improper capitalization of costs that clearly should have been expensed;

b. The Company's had a pattern of holding disconnects, which contributed to a significant rise in account receivables that should have been promptly written off; and,

c. The Company improperly accounted for other matters, such as including all launch fees paid by program providers at the initial date of a contact, rather than over the entire term of the contract.

d. Though aware that Charter was seeking to boost its revenues by paying vendors higher prices at the same time it received additional advertising from the same vendors, Andersen failed to properly audit these transaction by confirming them with the vendors.

194. Defendant Arthur Andersen thereby violated § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

COUNT V

VIOLATIONS OF § 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 PROMULGATED THEREUNDER AGAINST SCIENTIFIC-ATLANTA AND MOTOROLA

195. Lead Plaintiff incorporates by reference all of the foregoing paragraphs as if realleged herein.

196. As detailed above, defendants Scientific-Atlanta and Motorola engaged in a series of sham transactions whereby it agreed to return to Charter monies paid for

additional charges paid for converter boxes and other cable related devices. Such monies were returned in the form of "advertising." Scientific-Atlanta and Motorola agreed to such sham transactions knowing or recklessly disregarding that Charter intended to inflate its reported results by recording the monies it received as revenues, while recording monies it paid to Scientific-Atlanta as capital expenses. Scientific Atlanta and Motorola also knew that analysts would be relying upon such reported amounts in making their recommendations regarding Charter's stock.

197. By virtue of such misconduct, Scientific-Atlanta and Motorola made materially misleading statements to Charter investors knowing or recklessly disregarding that such statements were false and misleading, and thereby violated § 10(b) of the Exchange Act and Rule 10b-5(b) promulgated thereunder, as set forth in ¶ 95(a)-(e), *supra*.

198. Alternatively, these sham transactions constituted a "device, scheme or artifice to defraud" and "an act, practice or course of business which operate[d] . . . as a fraud or deceit" upon Charter investors, in violation of Rule 10b-5(a) and (c), for which Scientific-Atlanta and Motorola are likewise liable.

PRAYER FOR RELIEF

WHEREFORE, Lead Plaintiff demands judgment:

a. Determining that the instant action is a proper class action maintainable under Rule 23 of the Federal Rules of Civil Procedure;

b. Awarding compensatory damages and/or rescission as appropriate against defendants, in favor of Lead

Plaintiff and all members of the Class for damages sustained as a result of defendants' wrongdoing;

c. Awarding Lead Plaintiff and members of the Class the costs and disbursements of this suit, including reasonable attorneys', accountants' and experts' fees; and

d. Awarding such other and further relief as the Court may deem just and proper.

JURY DEMAND

Lead Plaintiff hereby demands a trial by jury.

Dated: August 4, 2003

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No. 06-43

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF IN OPPOSITION FOR RESPONDENT MOTOROLA, INC.

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QUESTIONS PRESENTED FOR REVIEW

1. Whether a corporation that made no public statement on which investors relied and had no duty to speak to such investors can nevertheless be found liable in a private action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

2. Whether a private plaintiff can transform a claim against a corporation that allegedly aided and abetted another's fraud into an actionable claim under Section 10(b) of the Securities Exchange Act of 1934 by characterizing it as a "scheme to defraud" in violation of Exchange Act Rules 10b-5(a) and (c).

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, Respondent Motorola, Inc. discloses that it has no parent corporation and that no publicly held company owns more than 10% or more of its stock.

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INTRODUCTION

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994) ("*Central Bank*"), this Court interpreted the language in Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b) (2000), and held that there was no private right of action for aiding and abetting fraud under that statute. After *Central Bank* was decided, the Securities and Exchange Commission attempted to persuade Congress to amend Section 10(b) to permit civil claims for aiding and abetting. In response, Congress gave the SEC the authority to bring civil actions for alleged aiding and abetting under Section 10(b), but specifically declined to do so as to private plaintiffs. S. Rep. No. 104-98 at 19 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 698. In this case, Respondent Motorola, Inc. ("Motorola") is charged with entering into a business transaction with Charter Communications, Inc. ("Charter"), which Charter then fraudulently reported to the public in its financial statements. The United States Court of Appeals for the Eighth Circuit held that the allegations against Motorola constituted, at most, charges of knowingly aiding and abetting Charter and, therefore, were barred under *Central Bank*. As set forth below, this decision was squarely in line with overwhelming precedent interpreting *Central Bank* and defining the boundaries between action that constitutes a primary violation of Section 10(b) and action that constitutes aiding and abetting. Because this case raises no novel issues under *Central Bank* and the courts are not divided in interpreting that decision, the petition here does not meet this Court's standards for review.

OPINIONS BELOW, JURISDICTION AND STATUTORY PROVISIONS

Respondent Motorola incorporates by reference Petitioner's statements of the Opinions Below, Jurisdiction, and Statutory and Regulatory Provisions Involved.

STATEMENT OF THE CASE

According to the Complaint filed below,[1] over a period of forty-one months, Charter engaged in a series of fraudulent activities designed to artificially inflate its earnings in nearly two dozen different public financial statements. The only allegations concerning Motorola related to a transaction in the fourth quarter of 2000. According to the Complaint, in the transaction "Charter agreed to pay ... Motorola an additional $20 for each digital converter so long as [Motorola] repaid the same amount to Charter in the form of 'advertising.'" (Complaint ¶ 77.) As a result, the Complaint alleged, Charter "significantly and artificially inflate[d] [its] operating cash flow ... by treating the 'payments' from ... Motorola as 'revenues' when in fact they were simply the return of Charter's own monies." (*Id.* ¶ 78.)

It was undisputed below that it was Charter's public financial statements reflecting Charter's fraudulent accounting decisions that lay at the heart of the claims against Motorola.[2] Petitioner does not dispute the conclusion of the

1. References to "the Complaint" refer to the Amended Consolidated Class Action Complaint filed in this case on August 5, 2003 in the United States District Court for the Eastern District of Missouri.

2. Indeed, the Complaint alleged that Charter was able to accomplish its fraudulent objectives only by lying to its independent auditor, Arthur Andersen. (Complaint ¶ 80.)

Court of Appeals that Motorola "did not issue any misstatement relied on by the investing public, nor [was Motorola] under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) ("*In re Charter*"). Petitioner also does not challenge the findings of the District Court, set forth in the Court of Appeals' decision, that:

> Plaintiffs do not assert that [Motorola] made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by [Motorola]. Plaintiffs do not allege that [Motorola was] responsible for, or [was] involved with the preparation of Charter's allegedly false or misleading financial statements; Charter's allegedly improper internal accounting practices; or the allegedly false or misleading public statements made by Charter and its former executives. Plaintiffs also do not allege that any of the allegedly misleading statements . . . were made, seen or reviewed by [Motorola].

Id. at 991.

The Court of Appeals held that, given those facts, the claims made by Petitioner against Motorola were "nothing more than claims, barred by *Central Bank*, that [Motorola] knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs." *Id.* at 992. Accordingly, the Court of Appeals affirmed dismissal of the claims against Motorola. *Id.* at 993.

REASONS FOR DENYING THE PETITION

I. Summary of Argument

Under the holding of *Central Bank*, Motorola could only be liable under Section 10(b) in this case if it either (1) made a misstatement on which Charter shareholders relied in connection with the purchase or sale of a security or (2) breached a duty to disclose information to Charter shareholders. Petitioner's claim against Motorola was properly dismissed by the District Court because Motorola neither made a misstatement on which any shareholder of Charter could possibly have relied, nor did it have any duty to communicate any information to Charter shareholders. The Eighth Circuit correctly held that this was a classic charge of aiding and abetting another's fraud – barred under *Central Bank*.

The Eighth Circuit also correctly concluded, in accordance with *Central Bank*, that Petitioner's claim was not saved by characterizing Motorola's alleged conduct as a "scheme to defraud," actionable under subsections (a) or (c) of Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2006). Contrary to Petitioner's argument, this Court in *Central Bank* was not interpreting paragraph (b) of Rule 10b-5 – the *Central Bank* holding was explicitly based on this Court's reading of the enabling statute, Section 10(b) of the Exchange Act. *See* 511 U.S. at 178 ("Because this case concerns the conduct prohibited by § 10(b), the statute itself resolves the case . . . ."). Because the claim against Motorola failed to meet the "misstatement (or omission)" test of the statute, it cannot be prosecuted by a private plaintiff under Section 10(b) or, therefore, under *any* subparagraph of Rule 10b-5. Any other conclusion would allow a private plaintiff to avoid

Central Bank simply by alleging that conduct constituting aiding and abetting took place in the context of a "scheme to defraud."

As set forth below, the lower courts have consistently and correctly barred claims like those advanced by Petitioner in this case. Thus, the petition for a writ of certiorari should be denied.

II. The Law in This Area Is Not in "Disarray" – Courts Have Consistently Interpreted *Central Bank* to Foreclose Theories of Liability Like Petitioner's

Petitioner attempts to portray the Eighth Circuit's decision in this case as aberrational and contends that the law of aiding and abetting in circumstances similar to those here is in "disarray." Those contentions are inaccurate. To the contrary, the Eighth Circuit's decision was squarely in line with the decisions of this Court and the consistent interpretations of *Central Bank* by Courts of Appeals and District Courts that have considered this issue.

In *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215 (10th Cir. 1996), the U.S. Court of Appeals for the Tenth Circuit held that *Central Bank* precludes liability for secondary actors under Section 10(b) unless they "themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors." *Id.* at 1226.

Similarly, in *Ziemba v. Cascade International, Inc.*, 256 F.3d 1194 (11th Cir. 2001), the Eleventh Circuit rejected the plaintiff's attempt to hold a law firm and accountants liable

as primary violators where none of the alleged misstatements or omissions were attributable to either defendant. *Id.* at 1213.

In *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), the Second Circuit took the same position, holding that "[i]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement." *Id.* at 175 (internal quotation marks omitted). The court concluded that the plaintiff's attempt to hold an accountant primarily liable under Section 10(b) could not be permitted, reasoning that to do so "in spite of [the accountant's] clearly tangential role in the alleged fraud would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in *Central Bank*." *Id.* at 175 (internal quotation marks omitted). The Second Circuit explained that "because § 10(b) and Rule 10b-5 focus on fraud made in connection with the sale or purchase of securities, a defendant must 'know or should know' that *his* representation would be communicated to investors." *Id.* at 175 (emphasis in original).

The Sixth Circuit came to the same conclusion in *Fidel v. Farley*, 392 F.3d 220 (6th Cir. 2004). In that case, a private plaintiff claimed that a company's outside auditor should be primarily liable under Rule 10b-5 for failing to obtain updated financial information from the company prior to the company's issuance of certain offering documents and a registration statement, both of which included unaudited data. *Id.* at 226. The court held that because the defendant auditor had not made any statement in connection with the registration statement or the offering documents, it could not be liable under Section 10(b) or Rule 10b-5: "holding [the auditor] liable for either its alleged implicit endorsement of

the unaudited financial figures or for its failure to insist on a correction to these figures would effectively revive aider and abettor liability in contravention of [*Central Bank*]." *Id.* at 235. In short, because the auditor did not make the misstatement, the Sixth Circuit concluded that it could not be liable under Section 10(b). *Id.*

District Courts in other circuits have followed the same interpretation of *Central Bank*. For example, in *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549 (S.D. Tex. 2002), the U.S. District Court for the Southern District of Texas held that § 10(b) liability may only be imposed for secondary actors who have created a document containing a misrepresentation upon which investors relied. *Id.* at 692. That court followed the same reasoning in *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 310 F. Supp. 2d 819 (S.D. Tex. 2004), where Merrill Lynch was alleged to have issued "numerous analysts' reports and recommendations containing false and misleading statements about Enron's financial condition, as part of the purported [Enron] Ponzi scheme." *Id.* at 829.[3]

The same interpretation of *Central Bank* controlled the court's decision in *In re Global Crossing, Ltd. Securities Litigation*, 322 F. Supp. 2d 319 (S.D.N.Y. 2004) ("*Global Crossing*"), another case in which a defendant made an actionable public statement. *See id.* at 330-31. The *Global Crossing* court allowed a claim based on a "scheme" theory

3. Unlike the defendants in *Enron*, there is no allegation in the Complaint that Motorola "created a document" containing misrepresentations upon which Petitioner relied in this case. Rather, those misrepresentations were made by Charter and, as noted above, *supra* note 2, only after Charter lied to its independent auditor. (Complaint ¶ 80.)

to proceed against Global Crossing's outside auditor based on allegations that the auditor was the "chief architect and executor" of the alleged scheme at Global Crossing, and that, as auditor, the defendant had issued public statements in the form of the audit opinion. *Id.* at 336. No similar allegations have been, or could have been, made against Motorola in this case.

III. The Eighth Circuit Correctly Applied This Court's Precedent

A. Charter, Not Motorola, Is the Only Potential Defendant Under the Facts Alleged

The Eighth Circuit's decision below was squarely in line with *Central Bank* and the foregoing lower-court holdings. Motorola entered into a transaction with Charter in the fourth quarter of 2000. (Complaint ¶ 7.) Charter lied to its independent auditors about the transaction in order to account for it improperly. (*Id.* ¶ 80.) Charter then issued public statements containing the improper accounting for the Motorola transaction. (*Id.* ¶¶ 78-79, 111-114). Charter's investors then allegedly relied to their detriment on the improper statements made by Charter. (*Id.* ¶¶ 183-184).

As the Court of Appeals made clear, there is no allegation in the Complaint that Motorola had anything to do with this alleged scheme other than entering into the transaction with Charter. *In re Charter*, 443 F.3d at 992-93. There are no allegations that Motorola made any false statement to Charter's investors concerning those agreements; that Motorola participated in any allegedly fraudulent statements made by Charter; or, indeed, that Motorola participated in deciding how Charter would account for the contracts or in

the preparation of the fraudulent financial statements that form the basis of the Complaint. *Id.* at 992. Thus, assuming *arguendo* the truth of Petitioner's allegations against Motorola, the most that Petitioner can prove is that Motorola aided and abetted Charter in Charter's misstatements.

This Court held in *Central Bank* that "[a] plaintiff must show reliance on *the defendant's* misstatement or omission to recover under [Rule] 10b-5." 511 U.S. at 180 (emphasis added). According to allegations in the Complaint, Petitioner relied on Charter's misstatements, and not on any statement by Motorola. (Complaint ¶¶ 7-8, ¶¶ 95-145.) That ends the inquiry. As the Court explained in *Central Bank*, the requirement to prove reliance precludes a Rule 10b-5 claim against someone who did not make the statement in question, but was alleged only to have aided and abetted another's violation:

> Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied on the aider and abettor's statements or actions. Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.

511 U.S. at 180 (citation omitted).[4] The Complaint plainly does not allege that any Charter investor relied on any public statement by Motorola.

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4. As the Tenth Circuit explained: "[t]he critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations made by others cannot itself form the basis of liability." *Anixter*, 77 F.3d at 1225.

Motorola also had no duty to speak to Charter shareholders. In *Central Bank,* this Court emphasized that "'not every instance of financial unfairness constitutes fraudulent activity under § 10(b).'" 511 U.S. at 174 (quoting *Chiarella v. United States*, 445 U.S. 222, 232 (1980)). Thus, the Court held that what Section 10(b) and Rule 10b-5 "'catch[] must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.'" *Id.* In this case, at most, the claim is that Motorola *by its silence* facilitated Charter's alleged fraud. But, there is no allegation – nor could there be one – that Motorola had any duty to speak to Charter shareholders. Thus, under *Central Bank* and *Chiarella*, Petitioner has no Section 10(b) or Rule 10b-5 claim against Motorola.

B. Petitioner Cannot End-Run *Central Bank* by Alleging that Motorola Violated Rules 10b-5(a) and (c)

Petitioner argues that the claims in the case are predicated on violations of Rule 10b-5(a) and (c), which impose liability for employment of any "scheme or artifice to defraud or fraudulent act or course of business." According to Petitioner, *Central Bank* applies only to alleged violations of Rule 10b-5(b), prohibiting "false statements." Thus, under Petitioner's interpretation, anyone who can be alleged to have participated *in any way* in a "scheme or artifice to defraud" or a fraudulent "act" or "course of business" may be sued by a private litigant under Rule 10b-5 – even if the alleged conduct is aiding and abetting a misstatement, for which a lawsuit would be barred under *Central Bank*. The Eighth Circuit correctly rejected this argument. Indeed, no Court has adopted the expansive reading of Rules 10b-5(a) and (c) that Petitioner espouses here.

The principal problem with Petitioner's argument is that it disregards the express language used by this Court in *Central Bank*. In *Central Bank*, the Court made clear that "[b]ecause this case concerns the conduct prohibited by § 10(b), the statute itself resolves the case. . . ." 511 U.S. at 178; *see also id.* at 173 ("[T]he text of the statute controls our decision."). In other words, a "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." *Id.* at 173.[5] The Court held that "the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation." *Id.* at 177. In other words, this Court in *Central Bank* was not interpreting subsections (a), (b) or (c) of Rule 10b-5 when it held that there was no aiding and abetting liability; the Court was interpreting Section 10(b), the enabling statute. As the Court explicitly held, "[i]t is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text." *Id.*; *see also United States v. O'Hagan*, 521 U.S. 642, 651 (1997) ("Liability under Rule 10b-5 . . . does not extend beyond conduct encompassed by § 10(b)'s prohibition."); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) ("[D]espite the broad view of the Rule [10b-5] advanced . . . its scope cannot exceed . . . 10(b).").

Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act" in connection with the purchase or sale of a security. *Central Bank*, 511 U.S. at 177. Clearly, Petitioner's Complaint in this case was based on the allegation that

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5. This holding was not the first time the Supreme Court had made this principle clear. *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1997) ("[T]he language of the statute must control the interpretation of the Rule.").

Charter made fraudulent misstatements in nearly two dozen different public pronouncements made over an approximately forty-one-month period. (Complaint ¶¶ 95-145.) As set forth above, the "misstatement" prong of Section 10(b) provides no basis for a claim against Motorola, since Motorola made no misstatements to Charter investors in connection with the purchase or sale of Charter's securities and had no duty to speak to those shareholders.

The "manipulation" prong of Section 10(b) also does not provide a basis for a claim against Motorola. As the Eighth Circuit correctly held, the term "manipulation" as used in Section 10(b) is, as explained by this Court, "'virtually a term of art when used in connection with securities markets.'" *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1997) (quoting *Ernst & Ernst*, 425 U.S. at 199). Section 10(b) uses the term "manipulation" in a technical sense to "refer[] generally to practices such as wash sales, matched orders or rigged prices, that ... mislead investors by artificially affecting market activity." *Santa Fe Indus.*, 430 U.S. at 476-77. Thus, a claim for "manipulation" requires "practices in the marketplace" which essentially have the effect of "tampering with the price" of securities. *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979); *see also Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005) ("[W]here the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a market manipulation claim under Rule 10b-5(a) and (c). . . ."); *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 205 (3d Cir. 2001) (explaining that Section 10(b) liability requires either a misstatement or, under the "manipulation" prong, the creation of "a false impression of market activity"). The acts alleged by Petitioner in the Complaint against Motorola do not constitute "manipulation" as that term is used in Section 10(b).

What this means is that there is no basis in this case to argue that the alleged conduct in issue here by Motorola – which is aiding and abetting that cannot violate Section 10(b) – can nevertheless be an actionable violation of subparagraphs (a) and (c) of Rule 10b-5 as an alleged "scheme to defraud." To accept this argument would both disregard and eviscerate *Central Bank*. Thus, the attempt by Petitioner to create broad liability for any "scheme to defraud" was correctly rejected by the Eighth Circuit.[6]

Contrary to Petitioner's assertion, that conclusion is also consistent with this Court's decision in *SEC v. Zandford*, 535 U.S. 813 (2002). That case involved a claim against a broker who sold securities to the plaintiff with the intention of misappropriating the proceeds. Petitioner asserts that *Zandford* allows a claim to proceed based on a "scheme to defraud" without the need for a misstatement. But Petitioner glosses over the holding in that case – that "any distinction between omissions and misrepresentations is illusory *in the context of a broker who has a fiduciary duty* to her clients." *Id.* at 823 (emphasis added). Unlike Motorola, the broker defendant in *Zandford* had a duty to inform the plaintiff of material information, and the failure of that broker to do so constituted an actionable material omission in connection with the purchase of a security – a quintessential violation

6. *See also In re Dynegy Sec. Litig.*, 339 F. Supp. 2d 804, 916 (S.D. Tex. 2004) ("Under *Central Bank* the aid that Citigroup provided Dynegy [in structuring misreported transactions] is not actionable under § 10(b), and plaintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent *Central Bank*'s limitations on liability for secondary actor's involvement in the preparation of false and misleading statements."); *Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1288 (D. Utah 1999) ("*Central Bank* applies with equal force to subsections (a), (b), and (c) of Rule 10b-5").

of Section 10(b). *Zandford* was thus consistent with both *Central Bank* and *Chiarella* in that silence by a secondary actor is actionable under Section 10(b) where the secondary actor is under a duty to speak. It is undisputed that Motorola had no such duty to Charter's shareholders.

C. The Ninth Circuit's Recent Decision in *Simpson v. AOL Time Warner* Does Not Provide Grounds to Grant the Writ

Contrary to Petitioner's suggestion in its Supplemental Brief, the Ninth Circuit's decision in *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006) ("*AOL Time Warner*"), has created no conflict of authority in the courts of appeals. In *AOL Time Warner*, plaintiff shareholders alleged that Homestore.com, an internet company, committed securities fraud by overstating reported revenues, 452 F.3d at 1042. They alleged that various third-party vendors participated in that fraud by entering into "sham transactions" with Homestore.com. *Id.* The District Court dismissed the complaint in reliance on *Central Bank*, *id.*, and the Ninth Circuit *affirmed* in relevant part, *id.* at 1054 ("Because the [complaint] does not allege a valid claim for primary liability under any theory of liability, the district court properly dismissed the claims in the [complaint] against the Defendants.").[7] *Relying on the Eighth Circuit's opinion in the present case*, the Ninth Circuit in *AOL Time Warner* explained that participation in a transaction that does not itself deceive anybody cannot give rise to "a primary violation even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud.

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7. The Ninth Circuit remanded the case, however, holding that the plaintiffs should have an opportunity to replead. 452 F.3d at 1055.

See In re Charter Commc'ns, Inc., Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006)." *AOL Time Warner*, 452 F.3d at 1050. The Ninth Circuit held that primary liability under Section 10(b) "requires more than assertions of 'helping' or 'assisting' another's deception," and concluded that the plaintiffs' allegations of sham transactions amounted to, at most, aiding and abetting. *Id.* at 1052.

Contrary to Petitioner's assertion, the Ninth Circuit's comments in *AOL Time Warner* are not a proper basis for a writ of certiorari. Petitioner's argument relies upon language in that opinion that was unnecessary to the Ninth Circuit's disposition of the case. After affirming the District Court's holding, the Ninth Circuit went on to posit that a plaintiff could meet the requirements of Section 10(b) by alleging that a defendant "engaged in a deceptive act," which it defined as an act undertaken with "the purpose and effect of creating a false appearance." *Id.* at 1052. By definition, these statements were dicta.

Supreme Court Rule 10(a) provides that, in exercising its judicial discretion to grant or deny a petition for a writ of certiorari, the Court considers whether "a United States court of appeals has entered a *decision* in conflict with *the decision* of another United States court of appeals on the same important matter." Sup. Ct. R. 10(a) (2005) (emphases added). Although Rule 10(a) does not control or limit this Court's discretion, *id.*, it reflects the fundamental premise that this Court sits in review of judgments and not "statements in opinions," *California v. Rooney*, 483 U.S. 307, 311 (1987), or "to correct errors in dicta," *Bunting v. Mellen*, 541 U.S. 1019, 1023 (2004) (Scalia, J. dissenting); *see also Layne & Bowler Corp. v. Western Well Works, Inc.*, 261 U.S. 387 (1923) ("[I]t is very important that we be consistent in not

granting the writ of certiorari except ... in cases where there is a real and embarrassing conflict of opinion and authority between the Circuit Courts of Appeal."). The Ninth Circuit's decision does not conflict with that of the Eighth Circuit or with those of any other court discussed *supra*. Its dicta are not grounds to grant the writ.

Moreover, certain aspects of the Ninth Circuit's opinion in *AOL Time Warner* suggest that there may be no real difference in its application of *Central Bank* from that employed in its sister circuits, including the Eighth Circuit here. The Ninth Circuit's putative requirement of a "purpose and effect of creating a false appearance," *see AOL Time Warner*, 452 F.3d at 1050; its reliance on the Eighth Circuit's reasoning in this case, *id.* (citing *In re Charter Commc'ns*, 443 F.3d at 992); and its holding that the plaintiffs had failed to state a claim on which relief could be granted, all suggest that, like the Eighth and other circuits, the Ninth Circuit would require allegations of some communicative or otherwise public fraudulent act in order to state a claim under Section 10(b) of the Exchange Act.

Thus, *AOL Time Warner* may present no conflict among the circuits. What ultimate position the Ninth Circuit may take in the *AOL Time Warner* litigation will depend on a variety of factors (*e.g.*, how plaintiffs replead and what the District Court decides if a motion to dismiss is filed) which can be reviewed by this Court, if necessary, if and when the *AOL Time Warner* case itself presents issues worthy of review. *See ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 516 n. 11 (1988) (finding "no reason to address" a Court of Appeals' "additional comments" that "were pure dictum"); *Rice v. Sioux City Mem'l Park Cemetery, Inc.*, 349 U.S. 70, 78 n.2 (1955) (citing instances of dismissal of certiorari where

"an asserted conflict turned out to be illusory"). On the other hand, if this Court views the Ninth Circuit's comments in *AOL Time Warner* as a true departure from *Central Bank*, the most direct and effective way to address that error would be on writ of certiorari to the Ninth Circuit.

* * *

Motorola respectfully submits that what Petitioner is really trying to do here is ask the Court to disregard *Central Bank* and its progeny. There is no reason given for this in the Petition and no argument as to why *Central Bank* was wrongly decided. In fact, Petitioner also disregards the fact that, as noted above, after *Central Bank* was decided, the SEC attempted to persuade Congress (in the context of consideration of what became the Private Securities Litigation Reform Act of 1995) to amend Section 10(b) to permit private claims for aiding and abetting. The SEC argued that Congress should "fully restore the aiding and abetting liability eliminated in the Supreme Court's Central Bank of Denver opinion." S. Rep. No. 104-98, at 48, *reprinted in* 1995 U.S.C.C.A.N. 679, 727. Although Congress decided to give the SEC authority to bring civil actions for alleged aiding and abetting, it specifically declined to do so as to private plaintiffs because "private aiding and abetting liability actions under [§] 10(b) would be contrary to S. 240's goal of reducing meritless securities litigation." S. Rep. No. 104-98, at 19, *reprinted in* 1995 U.S.C.C.A.N. 679, 698.

This is a classic case of alleged aiding and abetting. There is no private cause of action for this kind of alleged conduct. The Eighth Circuit saw the claim for what it was and properly dismissed it under *Central Bank*.

CONCLUSION

For the foregoing reasons, Motorola respectfully requests that the petition for a writ of certiorari be denied.

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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STATEMENT PURSUANT TO RULE 29.6

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

This supplemental brief is submitted to call attention to a decision handed down by the Ninth Circuit Court of Appeals on June 30, 2006, in *Simpson v. AOL Time Warner Inc.*, No. 04-55665, __ F.3d __, 2006 U.S. App. LEXIS 16556, 2006 WL 1791042 (9th Cir. June 30, 2006) ("*AOL Time Warner*"), which is in direct conflict with the decision of the Eighth Circuit Court of Appeals in the instant case. (*AOL Time Warner* was docketed after submission to printing of petition.)

In the *Stoneridge* case the Eighth Circuit "conclude[d] that *Central Bank* and the earlier cases on which it relied stand for three governing principles: . . . (2) A device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." 443 F.3d 989, 992.

In *AOL Time Warner*, the court rejected the contention that to "impose liability for conduct other than the making of a material misstatement or omission . . . would conflict with *Central Bank*." 2006 U.S. App. LEXIS 16556, at *24, 2006 WL 791042, at *8. The court stated "We see no justification to limit liability under § 10(b) to only those who draft or edit the statements released to the public. To the contrary, § 10(b) prohibits any person or entity from using or employing any deceptive device, directly or indirectly, in connection with the purchase and sale of securities." *Id.* (citations omitted).

In distinguishing between primary violators of § 10(b) and those who merely aid and abet a violation the court in *AOL Time Warner* held that to be liable as a primary violator for participation in a scheme to defraud the defendant's own conduct contributing to the overall scheme must have had a

deceptive purpose and effect. The court agreed with the position of the SEC in its *amicus* brief that such a conduct constitutes a deceptive act under § 10(b). Merely assisting another's conduct, however, but failing to perform an action that created a false appearance as part of the scheme would not be sufficient.

> The focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only those defendants who use or employ a manipulative or deceptive device) are held liable under the Act.

2006 U.S. App. LEXIS 16556, at *25, 2006 WL 1791042, at *8.

The conduct of Respondents in *Stoneridge* clearly would satisfy the test established by the Ninth Circuit. As discussed in the Petition, Respondents themselves engaged in conduct which had "a deceptive purpose and effect." Each Respondent engaged in the backdating of the advertising contract with Charter which had the deceptive purpose and effect of severing what was actually an integral relationship between those contracts and the monies that Charter was funneling to Respondents to pay for the advertising. Moreover, Respondent Motorola agreed to camouflage $10,800,000, which it received from Charter as "liquidated damages" and with which it then purchased advertising from Charter that it did not need. Similarly, Respondent Scientific-Atlanta falsely claimed that it was increasing the prices of set top boxes to be paid by Charter to conceal the true nature of $6.73 million, which it received from Charter and which it returned to Charter by purchasing advertising.

The determination of what constitutes a primary violation of § 10(b) is far too important an issue to be governed by the fortuity of the forum in which a case is being litigated. This Court should bring certainty where there is currently clear cut disagreement.

CONCLUSION

The petition for a writ of certiorari should be granted.

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No. 06-43

IN THE

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STATEMENT PURSUANT TO RULE 26.9

Petitioner's corporate disclosure statement was set forth on page ii of its Brief on the Merits. There are no amendments to that statement.

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INTRODUCTION

1. The question presented in this case is whether the text of Section 10(b) and Rule 10b-5 encompasses respondents' alleged conduct, or whether that conduct amounts to no more than aiding and abetting. The court of appeals ruled that because respondents "[did] not make or affirmatively cause to be made a fraudulent misstatement or omission," they did not commit a "deceptive device or contrivance" in violation of Section 10(b) and were "at most guilty of aiding and abetting," not actionable under *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). Pet. App. 9a.

Our opening brief demonstrated that this conclusion is wrong; respondents' own conduct violated the plain language of Section 10(b). They entered into sham agreements to create the illusion that they had purchased advertising from Charter, then manufactured a false paper trail to mislead Charter's auditors regarding those transactions. SAC ¶¶ 97, 102-03, 110, J.A. 54a, 57a, 59a-60a. The Solicitor General agrees that the "court of appeals erred by concluding that petitioner had failed to satisfy Section 10(b)'s deception requirement." U.S. Br. 9. "When measured against the correct standard," respondents' own conduct "constituted a 'deceptive device or contrivance.'" *Id.* at 16.

This conclusion is sufficient to resolve this case. The issue on which the Court granted certiorari – the issue that divides the courts of appeals – is whether deceptive conduct like respondents' constitutes a violation of Section 10(b). Respondents, no doubt sensing the weakness of their position given the plain language of Section 10(b) and *Central Bank*'s holding that the language of the statute governs, introduce a cornucopia of other arguments. *See, e.g.*, Resp. Br. 22-23, 23-24, 26-28. All are without merit. More importantly, they were manifestly not the basis of the court of appeals' decision, and were raised only glancingly below. While these arguments may

be available to respondents on remand, they should not be considered at this time.

2. The non-textual argument that respondents emphasize most heavily (indeed, much more heavily than any argument based on the text) is the assertion that the claim in this case does not satisfy reliance. We respectfully submit that this Court should not decide the reliance question in this case but should instead wait for a case in which that issue is squarely presented and fully briefed.

The issue of reliance plainly was not the basis for the court of appeals' decision. Reliance in securities fraud cases is a complex issue. As this Court observed in *Basic Inc. v. Levinson*, 485 U.S. 224, 243-44 (1988), "positive proof of reliance" is not always required, and the "understanding of Rule 10b-5's reliance requirement must encompass the[] differences" between "modern securities markets" and "the face-to-face transactions contemplated by early fraud cases." (footnote omitted).

Respondents and the Solicitor General urge a position on reliance that would effectively amend Section 10(b) to eliminate its prohibition of a broad range of "deceptive device[s] [and] contrivance[s]" that the Solicitor General concedes are encompassed by its plain language. Only materially false statements and omissions would be banned. This position conflicts with *Basic* and the views of the SEC. U.S. Br. 23 n.13. The SEC voted to submit a brief supporting petitioner in this appeal and confirming the positions on reliance and the availability of scheme liability set forth in amicus briefs it filed in *Simpson v. AOL Time Warner Inc. (Calif. Teachers Ret. Sys. v. Homestore.com, Inc.)*, 452 F.3d 1040 (9th Cir. 2006), *petition for cert. pending*, No. 06-560 (filed Oct. 19, 2006). *See* Test. of Christopher Cox, App.1-7 to Conyers/Frank Br.

In these circumstances – where a complex and novel issue was not decided by the court of appeals, and where a decision by this Court could have a dramatic and adverse effect on the meritorious private securities litigation it has long recognized

to be "an essential supplement" to criminal and civil enforcement proceedings (*see Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007)) – the Court should reserve judgment until the issue is more squarely presented.

3. In any event, respondents' and the Solicitor General's reliance arguments are erroneous. As the Court noted in *Basic*, the purpose of reliance is to "provide[] the requisite causal connection between a defendant's misrepresentation," or other violation of Section 10(b), "and a plaintiff's injury." 485 U.S. at 243. Here, there is causation, both "but for" and proximate. Petitioner relied upon financial statements recognizing respondents' sham revenues, and the auditor's certification of those statements. It is of no consequence that investors were unaware of the source of the revenue; financial statements rarely provide such details. What is important is that respondents anticipated that the phony figures would be disseminated by Charter and certified by its auditors, and would influence investors' decisions. Reporting $17 million in sham revenues to investors was the very purpose of the deceptive scheme. Misleading Charter's auditors was a crucial means to that end.

Respondents and the Solicitor General appear to take the view that reliance can be satisfied only when a defendant directly conveys a false statement to the public. *See* U.S. Br. 22; Resp. Br. 17. This view is inconsistent with the language of Section 10(b). As the Solicitor General recognizes, Section 10(b) applies to "any person" who "employ[s]" a "deceptive device or contrivance"; it is not limited to entities that convey information directly to investors. U.S. Br. 16-17. Moreover, *Basic* holds that reliance may be established even if a plaintiff was wholly unaware of a fraudulent statement, and emphasizes the need for flexibility in determining reliance in a Rule 10b-5 action. 485 U.S. at 242-44. The rigid position taken by respondents and the Solicitor General conflicts with the statute and this Court's decisions.

Respondents assert that their position is based on what they call "the reliance requirement" of *Central Bank*. Resp. Br. 13. But there is no such animal. Reliance was not at issue in *Central Bank*. That decision emphasizes the central importance of the language of Section 10(b) and holds that the text does not support liability for mere aiding and abetting. *See* 511 U.S. at 173-78. Its discussion of reliance is limited to one paragraph, which recognizes that *Basic* defines the contours for the requirement and mentions reliance only to point out that aiders and abettors did not need to establish reliance to proceed under that theory. 511 U.S. at 180.

Respondents repeatedly raise the specter that a ruling in favor of petitioners on the reliance issue in this case will effectively reinstate aiding and abetting liability. But what precludes aiding and abetting liability is the language of Section 10(b) requiring deceptive conduct. *Central Bank* could not have made this point more explicitly. Conduct encompassed by the plain language of Section 10(b), as the Solicitor General concedes is the case with respondents' conduct here, constitutes a primary violation of the Act, not aiding and abetting. A judge-made expansion of the reliance requirement to immunize such conduct from liability would thwart, rather than serve, the purpose and the plain language of Section 10(b).

In the end, the excessively strict reliance requirement advocated by respondents and the Solicitor General would simply place an arbitrary limit on claims permitted by the plain language of Section 10(b) and this Court's decisions. Respondents and the Solicitor General argue at length that such a limitation is desirable as a policy matter. But when Congress comprehensively addressed private litigation under the Exchange Act just a decade ago, it left intact the relevant language of Section 10(b) and *Basic*'s flexible reliance requirement. If respondents and the Solicitor General believe

private enforcement of Section 10(b) should be further restricted, they should address their arguments to Congress, not to this Court.

ARGUMENT

I. Respondents' Own Deceptive Conduct Violated Section 10(b).

As we show in our opening brief, and as the Solicitor General agrees, respondents' own conduct alleged in the Second Amended Complaint unquestionably constitutes "deceptive device[s] or contrivance[s]" within the meaning of Section 10(b). Pet. Br. 6-12, 36-37; U.S. Br. 8, 16-17.

Such deceptive conduct can be readily distinguished from legitimate business activity and mere aiding and abetting. The test proposed by petitioner, for example, would require: (1) a deceptive act by the defendant itself; (2) creating a false appearance of material fact; (3) in furtherance of a scheme to defraud investors. Pet. Br. 32.[1] A plaintiff would also have to plead a strong inference of scienter in accordance with the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4, and *Tellabs*. The proposed test is not "nebulous" or "untethered," as respondents and their amici incorrectly assert. Courts applying similar tests have had no difficulty distinguishing between deceptive conduct and aiding and abetting, and have dismissed aiding and abetting claims at the pleading stage. *See, e.g.*, *Simpson*, 452 F.3d at 1052-55; *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 504-05 (S.D.N.Y. 2005).

[1] The indenture trustee in *Central Bank* would not face liability under petitioner's test. As was conceded in that case, the indenture trustee did not commit its own deceptive act. 511 U.S. at 191. It did not furnish the false appraisal or certify its accuracy at the time of the 1988 offering. *Id.* Moreover, as the court of appeals found, the trustee complied with the indenture and owed no duty of disclosure. *First Interstate Bank, N.A. v. Pring*, 969 F.2d 891, 901 (1992), *rev'd on other grounds sub nom. Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). It merely failed to obtain an additional appraisal before it was required by the indenture, which may have exposed the developer's fraud. 511 U.S. at 191.

II. Charter's Investors Relied Upon The False Appearance Of Fact Created By Respondents' Deceptive Conduct.

As discussed above, the Court can and should determine this appeal on the question presented alone: "As a general rule . . . we do not decide issues outside the questions presented by the petition for certiorari." *Glover v. United States*, 531 U.S. 198, 205 (2001). However, because respondents and the Solicitor General emphasize so heavily in their briefs reliance and other issues not resolved below, and because we have not previously had occasion to address them directly, we address here why these arguments cannot present alternative grounds for affirmance.

1. The term "reliance" does not appear in § 10(b), Rule 10b-5, or the pleading requirements of the PSLRA. As fashioned by the Court, reliance in § 10(b) actions requires only allegations of "the requisite causal connection" between a defendant's fraud and a plaintiff's injury. *Basic*, 485 U.S. at 243. This nexus may be established by reliance on "other deceptive conduct" or "actions," as well as misrepresentations. *Central Bank*, 511 U.S. at 180; U.S. Br. 19.[2]

"There is . . . more than one way to demonstrate the causal connection." *Basic*, 485 U.S. at 243. *Basic* recognized that securities are traded in markets that anonymously transmit information "in the processed form of a market price." *Id.* at 244. Investors presumptively rely on any fraud impacting that price, whether or not they know the identity of the perpetrator

[2] Though the Solicitor General criticizes petitioner for equating reliance with "but for" causation (U.S. Br. 20), that is exactly what reliance means: "In the securities realm, 'but for' causation is referred to as 'reliance, or transaction causation,' and 'proximate cause' is known as 'loss causation.'" *Berckeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195, 222 (3d Cir. 2006). His assertion that "but for" causation "does not distinguish primary from secondary liability" is equally misplaced. U.S. Br. 20. What distinguishes primary liability from secondary liability is whether a defendant itself committed deceptive acts proscribed by § 10(b).

or even the nature of the fraud. *Id.* at 244-47. In fact, the manipulative conduct also proscribed by § 10(b), by definition, can only induce indirect reliance on market price. *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977); *Stephenson v. Deutsche Bank AG*, 282 F. Supp. 2d 1032, 1056 (D. Minn. 2003). Indirect reliance is similarly recognized in common law. Restatement (Second) of Torts, § 533 (1976) provides that one who makes a fraudulent statement can be held liable not only by direct recipients, but also by those persons to whom he "intends or has reason to expect that its terms will be repeated or its substance communicated."

Though *Central Bank* cited *Basic* as setting forth the correct standard for reliance, respondents focus instead on this subsequent remark: "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." 511 U.S. at 180. But the Court's observation reflects only that lower court decisions allowed imposition of aiding and abetting liability *without any proof of reliance*. All that they required was proof that a secondary actor had knowingly and substantially assisted a primary violation. *See, e.g., K&S Partnership v. Cont'l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991), *cert. denied*, 505 U.S. 1205 (1992).

Nonetheless, respondents and the Solicitor General suggest that *Central Bank* endorsed a "bright line rule" categorically precluding investors from claiming they relied on the deceptive conduct of unknown secondary actors. Resp. Br. 30. But *Central Bank* says no such thing, and that leap of logic is flatly inconsistent with *Basic*, which contemplates that investors can rely on any material information entering the market, regardless of how it got there.[3] *See also United States v. O'Hagan*, 521

[3] The auditor cases cited in the Solicitor General's brief at 21-22 all involved accountants that did not commit their own deceptive acts, but merely failed to blow the whistle on management's fraud. See *Fidel* (Cont'd)

U.S. 642, 656 (1997) ("[A] fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons.") (quotation and citation omitted).

In scheme cases, reliance "is satisfied if the introduction of misleading statements into the securities market was the intended end result of a scheme to misrepresent revenue." *Simpson*, 452 F.3d at 1051; *see also* SEC Reply Br. in *Simpson* at 12 (reliance "is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act") <http://tinyurl.com/39qg44>; *Parmalat*, 376 F. Supp. 2d at 509 (reliance established where banks knew that "the very purpose of . . . their transactions" was to allow an issuer to convey a misrepresentation into securities markets). The Second Amended Complaint easily satisfies this standard.

The causal chain is not severed because Charter issued the inflated financial statements. The scheme was "not . . . complete until the fraudulent information ha[d] entered the securities market." *Simpson*, 452 F.3d at 1051. "Certainly where the making of the false statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation." SEC Br. in *Simpson* at 22 <http://tinyurl.com/34dmjy>.

Common law principles require the same conclusion, limiting "superseding" causes to those of independent origin that were not foreseeable. *See, e.g.*, 1 DAN B. DOBBS, THE LAW OF TORTS 462 (2001); *Archer v. Warner*, 538 U.S. 314, 326 (2003) (Thomas, J., dissenting). Here, respondents anticipated and intended the resulting publication of false financial statements to investors.

(Cont'd)

v. Farley, 392 F.3d 220 (6th Cir. 2004), *Wright v. Ernst & Young, LLP*, 152 F.3d 169 (2d Cir. 1998), and *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997). To the extent that these cases suggest that *Central Bank* would immunize the auditors from liability if they did commit their own deceptive acts, they misread the Court's decision and the plain language of Section 10(b).

2. Respondents do not dispute that the false appearance they created added $17 million in phony revenue and operating cash flow ("OCF") to the financial statements Charter published.[4] As public companies themselves, respondents knew that Charter was required by law to publish quarterly and annual financial statements reporting revenues and OCF, and understood that the very purpose of the sham transactions was to inflate those figures.[5] *See* SEC Regulation S-X, 17 C.F.R. § 210. Congress and the SEC anticipated that investors would rely on those financial statements, requiring their publication "*for the proper protection of investors* and to insure fair dealing in the security." 15 U.S.C. § 78m(a) (emphasis added).

Because the fraud here occurred in the fourth quarter, and annual financial statements must be audited, the sham nature of the transactions had to be concealed from Charter's auditors. Again, respondents' deceptive acts were critical. As the Solicitor General acknowledges, respondents' false paper trail was intended to, and did, mislead Charter's auditors regarding these transactions. U.S. Br. 8. Respondents do not suggest any other intent. *See* Resp. Supp. Br. 3 (arguing that it is irrelevant whether their transactions "misle[]d Charter's outside accountants").[6]

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[4] This result did not depend on any complex accounting treatment. No accounting convention allows recognition of revenue for goods or services secretly paid for with the seller's own money.

[5] Respondents' assertion that they did not falsify their own financials is irrelevant. As alleged, the scheme was designed and intended to inflate Charter's financials, not those of respondents.

[6] The indictment in *United States v. Barford*, No. 4:03 CR 00434 (E.D. Mo. July 24, 2003), ¶¶ 22-23 <http://tinyurl.com/2pwrwk>, confirms respondents' knowledge and intent. Though respondents on page 9 of their brief blur together parts from two separate paragraphs of the indictment to suggest a meaning entirely different from the actual text, the indictment itself leaves no doubt that Respondents understood how the scheme was to operate and the role their own deceptive conduct played in misleading Arthur Andersen.

By misleading Charter's auditors, respondents knew that they were endangering investors. The auditing of financial statements is required "for the proper protection of investors." 15 U.S.C. § 78m(a); *see also United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) (auditors serve as a "public watchdog" for investors). "The significance of . . . audit reports to investors in this country is beyond question." *Teachers' Ret. Sys. v. A.C.L.N., Ltd.*, No. 01 Civ. 1184, 2003 U.S. Dist. LEXIS 7869, at *9 n.6 (S.D.N.Y. May 9, 2003). Investors use audited financial statements "to make voting and investment decisions." SEC Final Rule 13b2-2: Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,828 (May 28, 2003).[7]

The causal chain alleged in the Second Amended Complaint is by no means attenuated. The deception of investors through falsified financial statements flowed directly from respondents' sham advertising "purchases" and their deception of the accountants engaged to audit those statements.

3. Neither respondents nor the Solicitor General dispute that the fraudulent financial statements reflecting the $17 million in phony advertising revenues reached investors. *See, e.g.*, SAC ¶¶ 143, 145, J.A. 75a-78a. Nor do they contest, as this Court explained in *Basic*, that Congress designed the Exchange Act to reflect its understanding that *all* false material information can impact the price investors pay for stock. *See* 485 U.S. at 245-46 (quoting H.R. Rep. 1383 (1934) for the proposition "that the market price of shares traded on well-developed markets reflects all publicly available information" and that "the hiding

[7] Respondents' supplemental brief misstates that Rule 13b2-2 and its authorizing statute, Section 303 of the Sarbanes-Oxley Act of 2002, are the "exclusive" remedies for their fraudulent conduct. Resp. Supp. Br. 3. But the statute itself says the exact opposite, directing the SEC to prepare *supplemental* investor protection rules: "No preemption of other law. The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder." 15 U.S.C. § 7242(c).

and secreting of important information obstructs the operation of the markets").

However, contrary to this understanding, they argue that the fraud-on-the-market presumption should be artificially limited to statements conveyed directly to the market by a given defendant. That arbitrary limitation does violence both to the reasoning of *Basic* and to the plain text of § 10(b), which proscribes deceptive conduct employed "directly or indirectly." 15 U.S.C. § 78j(b); *see also Simpson*, 452 F.3d at 1051 (fraud-on-the-market applies equally to scheme liability claims brought under Rule 10b-5(a) and (c)) (citing 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD, § 7:469 (2d ed. 2006)). At any rate, as the Solicitor General acknowledges, fraud-on-the-market is generally considered at the class certification stage rather than the pleading stage. U.S. Br. 24 n.14.

4. As alleged, the scheme's $17 million inflation of revenues and OCF was both qualitatively and quantitatively material. It made the difference between meeting and severely missing analyst expectations in the fourth quarter of 2000. SAC ¶ 143, J.A. 75a-77a. Moreover, the boost constituted *50%* of Charter's much-touted sequential OCF growth for the fourth quarter of 2000, demonstrating numerical significance.[8] Compare SAC ¶ 143 with ¶ 140, J.A. 74a-77a.

III. The Complaint Adequately Alleges Loss Causation.

The Second Amended Complaint also alleges loss causation. This case is at the pleading stage, which only requires a plaintiff "to provide a defendant with some indication of the

[8] Respondents and the Solicitor General misstate SEC Staff Accounting Bulletin ("SAB") 99 as recognizing a 5% threshold for materiality. In fact, SAB 99 states that "exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law," and specifically indicates that a lower percentage will be material where, as here, it "hides a failure to meet analysts' consensus expectations." 64 Fed. Reg. 45,150, 45,152 (Aug. 12, 1999).

loss and the causal connection that the plaintiff has in mind." *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 347 (2005).[9] The Second Amended Complaint alleges that Charter's stock fell 13% after an analyst raised concerns about "accounting practices, including . . . marketing deals with equipment vendors." SAC ¶¶ 178-79, J.A. 94a-96a. Moreover, it alleges that Charter's stock fell further after the risks created by the fraudulent scheme materialized. *See, e.g.*, SAC ¶ 181, J.A. 96a-97a (stock fell after Charter received a grand jury subpoena related, in part, to matters raised by this analyst); SAC ¶ 184, J.A. 97a (stock fell after Charter executives who designed scheme were forced to resign and Charter announced it would restate financials following a review of these matters). Thus, respondents have been provided the "indication" required by *Dura*.

Petitioner does not, as respondents incorrectly assert, seek to hold them liable for a $7 billion, multi-faceted scheme. As the Second Amended Complaint makes clear, respondents are liable only for losses caused by the fraudulent scheme to boost Charter's fourth quarter and year-end 2000 revenues and OCF. They are not charged with responsibility for the other schemes in which Charter engaged. Further, aggregate damages in the case do not approach the fantastical $7 billion suggested by respondents. As the district court explained, the $146.25 million partial settlement that it approved constituted "32% to 93%" of estimated recoverable damages. 2005 U.S. Dist. LEXIS 14772, at *21 (E.D. Mo. June 30, 2005). Respondents' maximum potential liability would be only a portion of the difference between those estimated damages and the settlement.

Congress addressed this issue in the PSLRA by requiring apportionment of liability. Courts in most cases must consider:

[9] Respondents and their amici conflate the proximate causation required by *Dura* with sole causation. *See e.g.*, Resp. Br. 33. As we show, this restrictive reading violates Congressional intent to apportion liability equitably among the multiple participants in a complex securities fraud. 15 U.S.C. § 78u-4(f)(3)(C).

(1) "the nature of the conduct" of each defendant; and (2) "the nature and extent of the causal relationship between the conduct of each such person and the damages incurred." 15 U.S.C. § 78u-4(f)(3)(C).

IV. Only Congress Can Carve Out A Safe Harbor Protecting Violators Of Section 10(b) And Rule 10b-5(a) And (c) From Civil Liability.

For sixty-five years, § 10(b) and Rule 10b-5(a) and (c) have banned schemes to defraud and business practices that operate as a fraud. 17 C.F.R. § 240.10b-5. When this Court confirmed the existence of a private cause of action, it did so for § 10(b) and Rule 10b-5 generally, not for a limited subset thereof. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). Similarly, when Congress recognized the "federal statutory claim" with the PSLRA, *see Tellabs*, 127 S. Ct. at 2512,[10] it left intact all the prohibitions set forth in § 10(b) and Rule 10b-5.

Accordingly, as this Court explained in *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, a private action can be brought for any of the "four kinds of manipulative or deceptive devices to which [Rule 10b-5] refers." 532 U.S. 588, 593 (2001). Petitioner's claims seek redress because respondents themselves engaged in two of these four kinds of deceptive conduct – a scheme to defraud and business practices operating as a fraud. 17 C.F.R. § 240.10b-5(a) and (c). No amount of repetition can render those claims an "extension" of existing law. Petitioner's claims fall squarely within the statute and rule as written.

In contrast, respondents seek judicial nullification. They improperly suggest that this Court, for policy reasons, transform *Central Bank* into a "bright line rule" immunizing deceptive conduct under Rule 10b-5(a) and (c), unless such conduct

[10] *See also Dura*, 544 U.S. at 346 (the PSLRA "makes clear Congress' intent to permit private securities fraud actions" under § 10(b) where, as here, the requisite elements are alleged).

consists only of a direct misrepresentation or omission. Resp. Br. 30. But as this Court recognized in *Tellabs*, shaping the contours of the private cause of action is now a job for Congress: "*It is the federal lawmaker's prerogative . . . to allow, disallow, or shape the contours of – including the pleading and proof requirements for – § 10(b) private actions.*" 127 S. Ct. at 2512 (emphasis added).[11]

Congress decided to shape the § 10(b) action by requiring heightened pleading of fraud and scienter, barring most state law securities class actions, staying discovery while a motion to dismiss is pending, and protecting those who play a smaller role in schemes to defraud by limiting their liability. 15 U.S.C. § 78u-4; 15 U.S.C. § 78bb(f). Though Congress also created certain safe harbors, *see, e.g.*, 15 U.S.C. § 78u-5, it chose not to amend Section 10(b) to immunize schemes to defraud. Any further safe harbors can only be adopted by Congress. *Tellabs*, 127 S. Ct. at 2512.[12]

V. Respondents' Textual Arguments Do Not Place Their Own Deceptive Conduct Outside Of The Broad Scope Of Section 10(b) And Rule 10b-5.

Unable to meaningfully dispute that their own conduct was deceptive, respondents raise a series of misplaced textual arguments attempting to avoid the broad prohibitions of § 10(b) and Rule 10b-5.

First, respondents' argument that vendors and business partners are somehow beyond the scope of § 10(b), Resp. Br.

[11] Most of the "contours" of private securities litigation that were previously shaped by this Court's decisions are now addressed by statute. *See, e.g.*, 15 U.S.C. § 78aa-1 (statute of limitations); 15 U.S.C. § 78u-4(f) (right of contribution); 15 U.S.C. § 78u-4(b)(2) (pleading of scienter); 15 U.S.C. § 78u-4(c) (purchaser/seller requirement).

[12] Representative Barney Frank, Chair of the House Committee on Financial Services, states that the Committee is willing to hold hearings to consider the safe harbor proposed by respondents. Conyers/Frank Br. 8.

29-31, does violence to both the text and structure of the statute. Section 10(b) prohibits deceptive conduct by "any person," a term "obviously meant to be inclusive," and eschews the limited categories used to restrict other provisions. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

Second, respondents' suggestion that § 10(b) proscribes only direct fraudulent conduct, Resp. Br. 26-28, is rejected by the very text of the statute, prohibiting "any person, *directly or indirectly*" from using or employing deceptive devices or contrivances. Respondents incorrectly posit that this language refers only to the manner in which the mails or wires are used. Resp. Br. 27. That conflicts with *Central Bank*, where this Court found that aiding and abetting liability was inconsistent with § 10(b) because it applied to persons who did not even indirectly engage in the conduct that section proscribes. 511 U.S. at 176; *see also Simpson*, 452 F.3d at 1049; *SEC v. Mandaci*, No. 00 Civ. 6635, 2004 U.S. Dist. LEXIS 19143, at *22 (S.D.N.Y. Sept. 27, 2004); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 862 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998) (all discussing direct or indirect use of a deceptive device or contrivance).[13]

Third, respondents submit that the terms "use or employ" do not embrace their alleged conduct, which they describe as passive. This mischaracterizes the Second Amended Complaint, which details respondents' own deceptive acts.[14]

---

[13] *Jama v. Immigration & Customs*, 543 U.S. 335, 343 (2005), cited by respondents, also undermines their tortured construction. *Jama* does state that a limiting clause modifies only the phrase it "immediately follows," but in § 10(b), the term "directly or indirectly" *immediately follows "any person,"* not the jurisdictional clause.

[14] Respondents further mischaracterize the allegations of the Second Amended Complaint in arguing they owed no "duty" to investors. Respondents are not charged with violating a general duty of disclosure. Rather, they are charged with affirmatively employing a deceptive device or contrivance in violation of § 10(b), a prohibition that applies to "any person," with or without a pre-existing duty.

Fourth, Sections 9 and 18 of the Exchange Act that "are close in structure, purpose, and intent to the 10b-5 action," actually support petitioner's position. *Musick, Peeler & Garrett v. Employers Ins.*, 508 U.S. 286, 295 (1993). Both § 9 and § 18 explicitly contemplate private claims against culpable third parties collaborating in the proscribed activities. *See* 15 U.S.C. § 78i(e) ("Any person who willfully participates" in a manipulative transaction can be subject to private liability); 15 U.S.C. § 78r(a) ("Any person who shall make or cause to be made" any false statement in an SEC filing can be subject to private liability); *see also Pinter v. Dahl*, 486 U.S. 622, 650 n.26 (1988) ("Congress knew of the collateral participation concept and employed it . . . throughout its unified program of securities regulation.").

Fifth, § 20(e), which provides supplemental SEC enforcement authority against defendants who knowingly assist the fraud of another but does not require proof of deceptive conduct, has no bearing here. In passing § 20(e), Congress chose not to restrict the scope of primary liability for persons, like respondents, who engage in their own deceptive acts. As Professor Fischel recognized in the very article the Court cited favorably in *Central Bank*, *see* 511 U.S. at 191, if aiding and abetting liability was abolished, deceptive conduct would "continue to be prohibited by the section and the rule. . . ." Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 69 CAL. L. REV. 80, 108 (1981).

Sixth, respondents' attempt to narrow the "in connection with" requirement violates *Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Dabit*, 547 U.S. 71, 85 (2006). As the Court explained in *Dabit*, it has consistently "espoused a broad interpretation" of this language. "[I]t is enough that the fraud alleged 'coincide' with a securities transaction." *Id.*; *see also O'Hagan*, 521 U.S. at 657. Where "multiple participants used or employed a deceptive device in furtherance of a scheme to misrepresent the reported revenues of a company, then all participants may be viewed as having acted in connection with

the purchase or sale of securities." *Simpson*, 452 F.3d at 1051; *see also Semerenko v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000), *cert. denied*, 531 U.S. 1149 (2001) (requirement satisfied where false appearance is disseminated "in a medium upon which a reasonable investor would rely," *e.g.*, SEC filings).

VI. The Policy Arguments Raised By Respondents And Their Amici Are Improper And Factually Misleading.

Respondents concede that policy arguments cannot override the plain language of Section 10(b) and Rule 10b-5. Resp. Br. 42. Yet they and their amici devote nearly 100 pages to policy arguments that are not only matters for legislative consideration, but are factually incorrect.

Most of these arguments propose that failing to recognize a judicial safe harbor for scheme liability would have a "chilling effect" on legitimate business activity. But as we show in section I above, legitimate business activity is not reached by the test proposed here. Moreover, as respondents admit, participation by vendors and business partners in a scheme to defraud is already "deterred" by stiff criminal and civil penalties, regardless of the outcome of this case. Resp. Br. 47-48. Even attempting to execute a scheme to defraud investors can be punishable by up to 25 years in prison. 18 U.S.C. § 1348. It will frequently also constitute mail or wire fraud, *see* 18 U.S.C. §§ 1341 and 1343, and/or violate Rule 13b2-2, 68 Fed. Reg. at 31,828.

Contrary to respondents' arguments, experience shows that prohibiting corporate fraud strengthens, not weakens, the national economy. Since Sarbanes-Oxley was passed in 2002, trade figures have skyrocketed.[15] U.S. exchanges have also benefited. For example, in the first half of this year, foreign IPO listings on U.S. exchanges reached "a record rate." Thomas J. Healey, *Sarbox Was The Right Medicine*, WALL ST. J., Aug. 9, 2007, at A13. Requiring honest dealings in securities markets has clearly not "chilled" legitimate business activity.

[15] *See, e.g.*, U.S. Census Bureau trade statistics available at http://tinyurl.com/2exjde.

In addition, when it promulgatec Rule 13b2-2, the SEC found that prohibiting deceptive acts that could corrupt financial statements *enhances national competitiveness*. 68 Fed. Reg. at 31,829 "[W]e do not believe that [provisions prohibiting improper influence of auditors] would impose any burden on competition." *Id.* If they "lead to increased investor confidence in financial reporting, they also may facilitate capital formation. An increased willingness of investors to participate in the securities markets might result in issuers being able to lower their cost of capital." *Id.*

Respondents' remaining policy arguments are collateral attacks on Congress's decision to permit securities class actions. These arguments, which assert that securities class actions are ineffective and circular, have nothing whatsoever to do with the issues before this Court. Nor do these patriarchal assessments reflect the views of actual investors. Institutional investors, and member organizations of such investors, responsible for managing over *$3 trillion* in investments have filed amicus briefs supporting petitioner's position and opposing a safe harbor for schemes to defraud. In contrast, respondents' conclusions are backed only by ideological think tarks, corporate lobbyists, lawyers, and securities industry insiders – not investors.

Additionally, respondents' assertions ignore the fact that securities lawsuits have been severely constrained by the PSLRA, resulting in a "permanent shift" downward in the number of filings. Cornerstone Research, *Securities Class Action Case Filings 2007 Mid-Year Assessment* (2007), at 3 <http://tinyurl.com/32jgly>. Since 2002, the number of filings has dropped by over 50%. Cornerstone Research, *Securities Class Action Case Filings 2006: A Year in Review* (2007), at 3 <http://tinyurl.com/3dqn5o>. At the same time, the dismissal rate at the pleading stage has nearly doubled. NERA, *Recent Trends in*

Shareholder Class Action Litigation, at 4 (Jan. 2007) <http://tinyurl.com/35h55r>. Congress has already curtailed the threat of non-meritorious litigation and *in terrorem* settlements.

Especially telling is the dearth of claims against third parties. For example, *only one suit* was filed against an accounting firm in 2006. Cornerstone, *2006 Review*, at 20. This dropoff has nothing to do with the availability or prohibition of scheme liability – accountants make direct, attributed representations in every annual report and prospectus filed by each of the 6,000+ fully-filing public companies listed on the New York Stock Exchange, Nasdaq, American Stock Exchange, and OTC bulletin board.

Finally, respondents' suggestion that SEC enforcement is sufficient is undermined by the SEC itself, which voted to support petitioner in this appeal and recognized that "[m]eritorious private actions under the federal securities laws serve an important role." SEC Br. in *Simpson* at 2. Moreover, while the SEC can seek recovery for investors under its "Fair Funds" provisions, it failed to do so for Charter investors, and lacks the mechanisms to effectively distribute recovered monies. Government Accountability Office, *SEC and CFTC Penalties*, GAO 05-670, at 29 (Aug. 2005) (the SEC had then distributed only $60 million, or 1.2%, of $4.8 billion in announced recoveries) <http://tinyurl.com/269b2w>.

CONCLUSION

Respondents' deceptive conduct violated Section 10(b) and Rule 10b-5. The Eighth Circuit's limited reading of the statute to prohibit only a fraudulent statement or omission was in error and its judgment should be reversed.

Respectfully submitted,

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69

(40)

No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

JOINT APPENDIX

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PETITION FOR CERTIORARI FILED JULY 7, 2006
CERTIORARI GRANTED MARCH 26, 2007

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Appendix B — Relevant Docket Entries Of The United States District Court For The Eastern District Of Missouri (St. Louis) 6a

Appendix C — Second Amended Consolidated Class Action Complaint For Violations Of Federal Securities Law Dated October 26, 2004 ..... 15a

The following opinion, judgment, and memorandums have been omitted in printing this Joint Appendix because they appear in the Appendix of the Petition for a Writ of Certiorari on the following pages:

Opinion of the United States Court of Appeals for the Eighth Circuit, Filed April 11, 2006 ..... 1a

Final Judgment of the United States District Court for the Eastern District of Missouri, Eastern Division, Dated February 15, 2005 ..... 12a

Memorandum and Order of the United States District Court for the Eastern District of Missouri, Eastern Division, Dated December 20, 2004 ..... 15a

Memorandum and Order of the United States District Court for the Eastern District of Missouri, Eastern Division, Dated October 12, 2004 ..... 30a

The Amended Consolidated Class Action Complaint for Violation of Securities Law has been omitted in printing this Joint Appendix because it appears at pages App. 1-88 of Respondent Scientific-Atlanta, Inc.'s Opposition to Petition for Writ of Certiorari.

APPENDIX A — RELEVANT DOCKET ENTRIES OF THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Court of Appeals Docket #: 05-1974

Filed: 04/08/2005
Termed: 04/11/2006

Nsuit: 3850 Securities/Commodities

Stoneridge Invest., et al v. Scientific-Atlanta, et al
Appeal From: U.S. District Court for the Eastern District of Missouri - St. Louis

Case Type Information:
1) Civil
2) Private
3) null

Originating Court Information:
District: 0865-4 : 4:02-cv-1186 CAS
Trial Judge: Charles A. Shaw, U.S. District Judge
Date Filed: 08/05/2002

Date Order/Judgment:	**Date NOA Filed:**
02/15/2005	03/07/2005

Prior Cases:
None

Current Cases:
None

Appendix A

In re: CHARTER COMMUNICATIONS, INC.,
Securities Litigation

CARMEN RODRIGUEZ, on behalf of herself and all others similarly situated; ANDREW BUDMAN; KRUPA BUDMAN; JILL D. MARTIN; JAMES L. GESSFORD; LEE POSNER; LAURENCE E. BALFUS;

Plaintiffs

STONERIDGE INVESTMENT PARTNERS, LLS;

Plaintiff - Appellant

JOHN DORTCH; GEORGE PIKE; MYTIEN NGO; PATRICIA MORROW; FRED B. STOREY; EVELYN GADOL; DAVID BIRNBAUM

Plaintiffs

v.

CHARTER COMMUNICATIONS, Inc.; JERALD L. KENT; CARL E. VOGEL; KENT D. KALKWARF; DAVID G. BARFORD; PAUL E. MARTIN; DAVID L. MCCALL; BILL SHREFFLER; CHRIS FENGER;

Defendants

SCIENTIFIC-ATLANTA, Inc.; MOTOROLA, Inc.;

Defendants - Appellees

Appendix A

ARTHUR ANDERSEN, LLP; PAUL G. ALLEN;
JAMES H. SMITH, III;

Defendants

GLICKENHAUS & CO.; AFA MANAGEMENT PARTNERS, L.P; WALTER MIXSON; EDWARD ALTOMARE; PATRICK ELLIOTT; CARLOS RODRIGUEZ; FRED ROSENBERG; TOMMIITA SENGVILAY; RUDOLPH WISE

Movant Below

Date Filed	Docket Text
	* * *
06/15/2005	BRIEF FILED - Brief of Appellant- Stoneridge 8,829 words w/addendum 10 copies - w/service 6/14/05 w/cd rom. Defects: no summ of arg (brief correction requested) [05-1974] [1919569]
06/15/2005	RECORDS received: Joint Appendix, consisting of 2 Volume(s) 3 copies. [05-1974]
	* * *
08/15/2005	BRIEF FILED - Brief of Appellee - Motorola in 05-1974. 30 pages - 10 copies - w/service 8/15/05. w/diskette [05-1974] [1940946]
08/15/2005	BRIEF FILED - Brief of Appellee - Scientific-Atlanta in 05-1974. 8,953 words w/addendum - 10 copies - w/service 8/15/05. w/diskette [05-1974] [1940951]
	* * *

Appendix A

08/29/2005	BRIEF FILED - Reply brief - Stoneridge in 05-1974. 6930 words - 10 copies - w/service 8/26/05 - w/diskette [05-1974] [1946473]

* * *

12/12/2005	ARGUED AND SUBMITTED IN ST. LOUIS, MO TO JUDGES James B. Loken, Circuit Judge, Roger L. Wollman, Circuit Judge, William J. Riley, Circuit Judge. Marc I. Gross for Appellant Stoneridge. Oscar Newton Persons for Appellees Scientific-Atlanta. Stephen M. Sacks for Appellees Motorola. Rebuttal by: Mr. Gross. RECORDED. [05-1974]
04/11/2006	THE COURT: James B. Loken, Roger L. Wollman, William J. Riley: OPINION FILED by James B. Loken, Authoring Judge PUBLISHED. [05-1974] [2031189]
04/11/2006	JUDGMENT: James B. Loken, Roger L. Wollman, William J. Riley. The judgment of the lower court is AFFIRMED in accordance with the opinion. [05-1974] [2031192]
04/19/2006	Record Sent out of the office to district court. Records Included: 2 vols. TR;. [05-1974]
05/22/2006	MANDATE ISSUED [05-1974]

* * *

Appendix A

07/17/2006	U.S. Supreme Court notice filed. Petition for writ of certiorari filed in the Supreme Court on July 7, 2006. Supreme Ct. Case No.: 06-43 [05-1974] [2068069]
03/29/2007	SUPREME COURT order filed GRANTING cert petition. The Chief Justice and Justice Breyer took no part in the consideration or decision of this petition. Order filed on 03/26/2007. [3293549] [05-1974]

APPENDIX B — RELEVANT DOCKET ENTRIES OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI (ST. LOUIS)

UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF MISSOURI
(LIVE)(ST. LOUIS)
CIVIL DOCKET FOR CASE #: 4:02-CV-01186-CAS

StoneRidge Investment, et al v. Charter Comm Inc., et al
Assigned to: Honorable Charles A. Shaw
Demand: $0
Lead case: *4:02-cv-01186-CAS (View Member Cases)*
Cause: 15:78m(a) Securities Exchange Act

Date Filed: 08/05/2002
Jury Demand: Both
Nature of Suit: 850
Securities/Commodities
Jurisdiction: Federal Question

CARMEN RODRIGUEZ, ANDREW BUDMAN, KRUPA BUDMAN, JILL D. MARTIN, JAMES L. GESSFORD, LEE POSNER, LAURENCE E. BALFUS, STONERIDGE INVESTMENT PARTNERS LLC, JOHN DORTCH,

Plaintiffs,

v.

GEORGE PIKE, MYTIEN NGO, PATRICIA MORROW, FRED B. STOREY, EVELYN GADOL, DAVID BIRNBAUM,

Consolidated Filer Plaintiffs,

v.

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CHARTER COMMUNICATIONS, INC., JERALD L. KENT, CARL E. VOGEL, KENT D. KALKWARF, DAVID G. BARFORD, PAUL E. MARTIN, DAVID L. McCALL, BILL SHREFFLER, CHRIS FENGER, SCIENTIFIC-ATLANTA (*TERMINATED: 10/12/2004*), INC., ARTHUR ANDERSEN, LLP, PAUL G. ALLEN, JAMES H. SMITH, III, MOTOROLA, INC. (*TERMINATED: 10/12/2004*),

Defendants,

v.

SUSAN LOCKSHINE, RORY A. VALAS,

Objectors,

GLICKENHAUS & CO., AFA MANAGEMENT PARTNERS LP, WALTER MIXSON, EDWARD ALTOMARE, PATRICK ELLIOTT, CARLOS RODRIGUEZ, FRED ROSENBERG, TOMMIITA SENGVILAY, RUDOLPH WISE, KOJA, LLC,

Movants.

Date Filed	**Docket Text**
08/05/2002	COMPLAINT; # Summons Issued: 4 # Days to Respond: 20 # Counts: 4 # Consents: 5 Disclosure of Corp Cert issued to: Charter Communications; jury demand exhibits attached: 1 (SET) (Entered: 08/07/2002)

* * *

Appendix B

01/16/2003	ORDER by Honorable Henry E. Autrey IT IS HEREBY ORDERED THAT: Stoneridge is hereby appointed as Lead Plaintiff; The Pomerantz Firm is hereby appointed as Lead Counsel; The firm of Wolff and D'Agrosa are hereby appointed Liaison Counsel IT IS SO ORDERED (cc: all counsel) (MJM) (Entered: 01/17/2003)

* * *

08/05/2003	MOTION by plaintiff Stoneridge Invest in 4:02-cv-01186 for leave to file amended class action complaint, and to amend the initial case management order (MRC) (Entered: 08/05/2003)
08/05/2003	RULED DOCUMENT by Honorable Charles A. Shaw - LEAVE GRANTED (CAS). granting plaintiffs' motion for leave to file amended class action complaint [112-1], granting motion to amend the initial case management order [112-2] (cc: all counsel) (MRC) (Entered: 08/05/2003)
08/05/2003	AMENDED CONSOLIDATED CLASS ACTION COMPLAINT by plaintiffs in 4:02-cv-01186 # Summons Issued: None # Waiver of Service Issued: None [90-1]; adding James H. Smith III, Motorola, Inc. to case(s) 4:02-cv-01186; jury demand (MRC) (Entered: 08/05/2003)

* * *

Appendix B

09/09/2003 MOTION by defendant Scientific-Atlanta in 4:02-cv-01186 to dismiss plaintiffs' Amended Consolidated Class Action Complaint with Memorandum of Law attached. (MRC) (Entered: 09/10/2003)

* * *

10/01/2003 MOTION by defendant Motorola, Inc. in 4:02-cv-01186 to dismiss pltf's amended consolidated class action complaint with memo in support attached. (KXS) (Entered: 10/02/2003)

* * *

10/24/2003 MEMORANDUM IN SUPPORT/RESPONSE to Motion re [133] Motion to Dismiss, [150] Motion to Dismiss *Memorandum of Law in Opposition to Scientific-Atlanta's and Motorola's Motions to Dismiss* filed by Plaintiff Stoneridge Investment Partners LLC. (Attachments: # *1* Table of Contents and Table of Authorities # *2* Certificate of Service)(Gross, Marc) (Entered: 10/24/2003)

* * *

11/14/2003 REPLY to Response to Motion re [150] Motion to Dismiss *Plaintiff's Amended Consolidated Class Action Complaint* filed by Defendant Motorola, Inc. (Murray, Robert) (Entered: 11/14/2003)

* * *

Appendix B

12/04/2003	REPLY to Response to Motion re [133] Motion to Dismiss *Plaintiff's Amended Consolidated Class Action Complaint* filed by Defendant Scientific-Atlanta, Inc. (Hurd, Susan) (Entered: 12/04/2003)

* * *

10/12/2004	MEMORANDUM AND ORDER - This matter is before the Court on several motions to dismiss for failure to state a claim. . . . IT IS HEREBY ORDERED that the stay in this action is lifted. IT IS FURTHER ORDERED that Scientific-Atlanta's motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is granted. IT IS FURTHER ORDERED that Motorola Inc's motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is granted. IT IS FURTHER ORDERED that Motorola's motion for a hearing on its motion to dismiss is denied. IT IS FURTHER ORDERED that Arthur Andersen's motion to dismiss Count IV of the amended consolidated class action complaint is denied. IT IS FURTHER ORDERED that the Joint Motion for a Protective Order is granted. IT IS FURTHER ORDERED that Arthur Andersen's motion for leave to file a surreply regarding the joint motion for a protective order is denied. IT IS FURTHER ORDERED that Scientific-

Appendix B

Atlanta's motion for leave to submit a supplemental memorandum regarding the joint motion for a protective order is denied. re:*250* MOTION for Leave to File Surreply Regarding Joint Motion for the Entry of a Protective Order filed by Arthur Andersen, LLP, [138] Motion to Dismiss filed by Arthur Andersen, LLP, *251* MOTION for Leave to Submit Supplemental Memorandum on Joint Motion for Entry of Proposed Protective Order filed by Scientific-Atlanta, Inc., *212* MOTION for Hearing re [150] Motion to Dismiss Plaintiff's Amended Consolidated Class Action Complaint filed by Motorola, Inc., *242* Joint MOTION for Protective Order filed by Charter Communications, Inc., Stoneridge Investment Partners LLC, [133] Motion to Dismiss filed by Scientific-Atlanta, Inc., [150] Motion to Dismiss filed by Motorola, Inc. Signed by Judge Charles A. Shaw on 10/12/2004. (MRC,) (Entered: 10/13/2004)

* * *

10/27/2004 MOTION to amend and reconsider dismissal of claims against defts Scientific Atlanta, Inc. and Motorola by Lead Plaintiff Stoneridge Investment Partners LLC. (Attachments: # *1* Exhibit A)(KXS,) (Entered: 11/12/2004)

* * *

Appendix B

11/12/2004	MEMORANDUM in Opposition re *264* MOTION to Amend/Correct MOTION for Reconsideration filed by Defendant Scientific-Atlanta, Inc. (Attachments: # *1* Exhibit A)(Kuhlman, Richard) (Entered: 11/12/2004)
11/12/2004	MEMORANDUM in Opposition re *264* MOTION to Amend/Correct MOTION for Reconsideration filed by Defendant Motorola, Inc. (Murray, Robert) (Entered: 11/12/2004)

* * *

11/24/2004	REPLY MEMORANDUM, and Reply Memorandum in Support of *264* Motion to Amend the Complaint and to Reconsider Dismissal of Claims Against Defts Scientific Atlanta, Inc. and Motorola, Inc. filed by Plaintiff Stoneridge Investment Partners LLC. (Attachments: # *1* Certificate of Service)(Gross, Marc) Modified on 11/29/2004 (KXS,). (Entered: 11/24/2004)
11/30/2004	MOTION for Leave to File Supplemental Memorandum In Response To Lead Plaintiff's Reply Memorandum In Support of its Motion To Amend The Complaint and To Reconsider Dismissal of Claims by Defendant Scientific-Atlanta, Inc. (Attachments: # *1*)(Kuhlman, Richard) (Entered: 11/30/2004)

* * *

Appendix B

12/20/2004	MEMORANDUM AND ORDER-. . . . IT IS HEREBY ORDERED that Stoneridge Partners motion to amend or correct is Granted in part and Denied in part. . . . IT IS FURTHER ORDERED that Stoneridge Partners motion for reconsideration is Denied. IT IS FURTHER ORDERED that Scientific-Atlanta's motion for leave to file a supplemental memorandum in support of its motion to amend the complaint and to reconsider dismissal of claims is Denied. IT IS FURTHER ORDERED that lead plaintiff shall file an amended complaint extending the Class Period by one month to conform with the evidence developed to date and the terms of the Partial Settlement by January 3, 2005. re *272* MOTION for Leave to File Supplemental Memorandum In Response To Lead Plaintiff's Reply Memorandum In Support of its Motion To Amend The Complaint and To Reconsider Dismissal of Claims filed by Scientific-Atlanta, Inc., *264* MOTION to Amend/Correct MOTION for Reconsideration filed by Stoneridge Investment Partners LLC Response to Court due by 1/3/2005. Signed by Judge Charles A. Shaw on 12/20/2004. (MRC,) (Entered: 12/20/2004)

* * *

Appendix B

01/11/2005	NOTICE OF APPEAL as to *276* Order, *252* Memorandum & Order, by Plaintiff Stoneridge Investment Partners LLC. Filing fee $ 255. (Attachments: # *1* Appellant's Form A)(Gross, Marc) (Entered: 01/11/2005)

* * *

01/13/2005	NOTIFICATION OF APPEAL AND NOA SUPPLEMENT by clerk to USCA regarding *252* Memorandum & Order, *279* Notice of Appeal, and *276* Order. Notice of Appeal filed on 01/11/05 by Plaintiff Stoneridge Investment Partners LLC. NOTIFICATION TO COUNSEL AND PRO SE PARTY: FILE REQUEST FOR TRANSCRIPT WITH DISTRICT COURT CLERKS OFFICE. SUBMIT FORM A & B TO EIGHTH CIRCUIT CLERKS OFFICE(CDF) (Entered: 01/13/2005)

* * * *

APPENDIX C — SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATIONS OF FEDERAL SECURITIES LAW DATED OCTOBER 26, 2004

Changes from prior Complaint in Bold

JURY TRIAL DEMANDED

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

MDL DOCKET NO. 1506 (CAS)
ALL CASES

Consolidated Case
No. 4:02-CV-1186 CAS

IN RE CHARTER COMMUNICATIONS, INC. SECURITIES LITIGATION

STONERIDGE INVESTMENT PARTNERS LLC, Individually and On Behalf of All Others Similarly Situated,
Plaintiff,

v.

CHARTER COMMUNICATIONS, INC., PAUL ALLEN, JERALD L. KENT, CARL E. VOGEL, KENT KALKWARF, DAVID G. BARFORD, PAUL E. MARTIN, DAVID L. McCALL, BILL SHREFFLER, CHRIS FENGER, JAMES H. SMITH, III, SCIENTIFIC-ATLANTA, INC., MOTOROLA, INC. and ARTHUR ANDERSEN, LLP,

Defendants.

Appendix C

SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATIONS OF FEDERAL SECURITIES LAW

Lead Plaintiff, by its attorneys, for its Consolidated Class Action Complaint alleges the following upon personal knowledge as to itself and its own acts, and upon information and belief based upon the investigation of Lead Plaintiff's attorneys as to all other matters. The investigation included the thorough review and analysis of public statements, publicly filed documents of Charter Communications, Inc. ("Charter" or the "Company"), press releases, news articles, **interviews with Charter employees, Charter internal documents, publicly filed trial transcripts in the matter of United States of America v. John Rigas, Timothy Rigas, Michael Rigas and Michael Mulcahey in the United States District Court Southern District of New York, 02 CR 1236 before the Honorable Judge Leonard Sand, and the review and analysis of accounting rules and related literature.**

The investigation also included extensive interviews with numerous former Charter employees from offices in virtually all regions in which the Company does business. Such employees include individuals who held varied and diverse positions with the Company: directors of operations and marketing, accounting managers, technical supervisors and customer service representatives. The allegations set forth herein reflect specific and credible information provided by such individuals regarding Charter's ongoing practices, which were often corroborated by multiple employees.

Appendix C

SUMMARY OF ACTION

1. This is a securities class action on behalf of investors who purchased the securities of Charter during the period from November 8, 1999, through **August 16, 2002 (the "Class Period").** Lead Plaintiff complains of a fraudulent scheme that injured purchasers of Charter stock during the Class Period.

2. Charter is headquartered in St. Louis, Missouri and purports to be the nation's fourth largest cable operator.

3. From the outset of the Class Period, Defendants portrayed Charter as a booming company which was experiencing a steady internal growth rate of new subscribers (in contrast to new customers from acquired companies), along with increased operating "cash flow" and reduced losses. Indeed, the Company boasted that its 2+% internal growth rate for new customers was the highest of the nation's large cable companies, and that it was likewise a leader in "operating cash flow" growth.

4. In order to maintain this upbeat image, defendants engaged in a pervasive and continuous fraudulent scheme intended to artificially boost the Company's customer base and reported financial results. But for this scheme, Charter would have reported no net increase in customers from internal growth. Moreover, Charter's critical growth rate of operating cash flow was materially inflated during 2001, and was only half the amount publicly reported.

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5. Among other things, defendants inflated Charter's internal customer growth rate by deliberately delaying "disconnects" for over 100,000 customers who were no longer paying their bills, or who had advised the Company they wished to terminate their service.

6. In addition, defendants materially inflated Charter's operating cash flow by improperly capitalizing labor-related and other costs that should have been expensed. Defendants also improperly recognized up front all revenues received in connection with the launch of new programming channels, rather than spreading such revenues over the term of the programming contract.

7. As a further device to inflate the Company's reported performance, Charter entered into kickback arrangements with defendants Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") **(collectively the "Vendor Defendants")**, the suppliers of key components for use by Charter's customers. During the fourth quarter of 2000, Charter agreed to pay Scientific-Atlanta and Motorola an additional $17 million for digital set-top boxes used by cable customers above and beyond the amounts ordinarily charged for such components. In exchange for these defendants agreed to kickback all those additional monies to Charter in the form of "marketing support payments." Charter booked the payments to Scientific-Atlanta and Motorola as capital expenditures (which were then depreciated over the life of the equipment, and thus not included in Charter's reported "operating cash flow" figures), while it improperly booked the "advertising fees" received from Scientific-Atlanta and Motorola as revenue (rather than a direct set-off against costs), thereby inflating revenues and cash flow.

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8. As detailed below, Scientific-Atlanta and Motorola knew that these transactions were absolute shams designed solely to give Charter the appearance of increased cash flow (as well as aid themselves by inflating their own revenues). Indicative of the sham nature of the transactions, Scientific Atlanta increased its prices to Charter by $20 per set for 351,180 sets (that the Company had already agreed to purchase) *only after Charter requested that the vendor send it a letter raising the price.* Coincidently, Scientific Atlanta agreed to purchase an equivalent amount of advertising from Charter.

9. As for Motorola, Charter agreed to buy 540,000 sets prior to the four remaining months of 2000 (*which represented the amount Charter had previously planned to purchase for all of 2001*), and then agreed to pay the vendor $20 for *each set that it failed to order by the end of the year.* At the same time, Motorola agreed to purchase an equivalent amount of advertising from Charter.

10. The Vendor Defendants not only knew that these transactions were shams, but knew that they were structured to inflate Charter's reported cash flow to investors, and thereby increase Charter's stock price. It was common knowledge that any time a media company was paid for advertisements, the revenue could be recognized as soon as the advertisements were run. It was also common knowledge that any purchases of equipment for use over an extended period of time would be capitalized over that period, thus spreading the cost over the period of use.

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11. Given the clearly fictitious nature of the transactions, which was not known to the public, and the manner by which these transactions were ordinarily accounted for, it is clear that the Vendor Defendants knew or recklessly disregarded the fraud upon Charter's investors that was caused by their scheme.

12. As a result of these fraudulent accounting practices, Charter's reported revenues and operating cash flow were materially inflated, and its losses were materially understated.

13. Defendants engaged in this multi-prong scheme for one purpose — to "meet the numbers" that Wall Street had projected for Charter, and thereby boost the price of the Company's stock, enabling it to acquire other companies using its inflated stock as currency.

14. On July 17, 2002, analysts voiced skepticism regarding some of Charter's accounting practices. Shortly thereafter, on August 16, 2002, the Company revealed that a federal grand jury was conducting a criminal probe of Charter's accounting for capital expenses, and its inflating the number of customer accounts. This followed the write-off of 145,000 customers by Charter earlier in the year, effectively wiping out all the previously reported internal subscriber growth.

15. On October 22, 2002, the Company announced that, due to the pendency of the Grand Jury proceedings, it was placing its Executive Vice President and Chief Operating Officer, defendant David G. Barford, on paid leave.

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16. Subsequently, on December 23, 2002, the Company announced that both Barford and the Company's Chief Financial Officer, defendant Kent D. Kalkwarf, had been fired following an internal investigation of various matters, including those related to the Grand Jury investigation. The Company also stated that its books and records for the years 2000 and 2001 were being reaudited by the Company's new accountants, KPMG LLP, who had replaced defendant Arthur Andersen LLP.

17. On February 10, 2003, it was publicly disclosed that the Grand Jury investigating Charter had subpoenaed records from Scientific-Atlanta.

18. On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. The Company acknowledged for the first time that its "operating cash flow," otherwise known as earnings before interest, taxes, depreciation and amortization ("EBITDA"), had been inflated for 2001 by 19.5% ($292 million), and for 2000 by 14.5% ($195 million). Most significantly, the Company acknowledged for the first time that whereas it had reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount.

19. The foregoing fraudulent practices materially inflated Charter's stock price. Increasing skepticism regarding the accuracy of the Company's prior disclosures caused Charter's stock price to fall from over $20 in late 2001, to less than $10 by July 2002. Following the disclosure of the Grand Jury Investigation, the price plummeted, falling

to a 52-week low of $0.76 on October 11, 2002, down approximately 97% from its Class Period high.

20. On July 24, 2003, the Grand Jury returned an indictment ("Indictment") against four of the defendants — David G. Barford, Kent D. Kalkwarf, David L. McCall and James H. Smith, III, charging that they "knowingly devised and intended to devise a scheme to defraud investors in Charter securities." The Indictment focused specifically on deliberate inflation of Charter's customer count, and the kickbacks from Scientific-Atlanta and Motorola. On July 25, 2003, defendant McCall entered a guilty plea, signed a Plea Agreement, Guidelines Recommendations and Stipulations ("Plea Agreement"), and acknowledged in Court that he had been instructed to inflate subscriber counts.

JURISDICTION AND VENUE

21. This Court has jurisdiction over this action pursuant to Section 27 of the Securities Exchange Act of 1934 (the "1934 Act"), 28 U.S.C. §§ 1331 and 1337. The claims asserted herein arise under Section 11 of the Securities Act of 1933 (the "1933 Securities Act"), 15 U.S.C. § 77 (k); Section 12 of the 1933 Securities Act, 15 U.S.C. § 77(l); Section 15 of the Securities Act, 15 U.S.C. § 77(o); Sections 10(b) and 20(a) of the 1934 Act, 15 U.S.C. §§ 78j(b) and 78t(a); and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder by the SEC.

22. Venue is proper in this District pursuant to Section 22 of the 1933 Act, 15 U.S.C. § 77(v); Section 27 of the 1934 Act, 15 U.S.C. § 78aa; and, 28 U.S.C. § 1391(b). Many

of the Charter Related Defendants reside in this District. Many of the acts giving rise to the violations complained of, including the dissemination of false and misleading public statements and financial information, occurred in this District.

23. In connection with the wrongs alleged herein, Defendants used the instrumentalities of interstate commerce, including the United States mails, interstate wire and telephone facilities, and the facilities of the national securities markets.

THE PARTIES

24. Lead Plaintiff StoneRidge Investment Partners LLC purchased shares of Charter common stock in the Company's Initial Public Offering on November 8, 1999, and during the Class Period, as set forth in its previously filed Certification, and was damaged thereby.

25. Defendant Charter is a Delaware corporation whose headquarters are located at 12405 Powerscourt Drive, St. Louis, Missouri 63131. Charter is a cable operator that provides video, data, interactive and private business network services to purportedly seven million customers in forty States through the Company's broadband network of coaxial and fiber-optic cable. The Company offers traditional analog cable as well as digital television services, along with an array of advanced products and services such as high-speed Internet access, interactive video programming and video-on-demand. By the end of the Class Period, Charter's customer base was approximately 7 million. As of May 24,

2002, Charter had 294,647,000 shares of common stock outstanding. Charter's shares trade on the Nasdaq National Market under the symbol "CHTR."

26. Defendant Paul Allen ("Allen") is the founder, Chairman and controlling shareholder of Charter. Defendant Allen owns 56% of Charter's outstanding shares through a holding company, Vulcan Ventures Incorporated, which is entitled to all of Charter's tax losses.

27. Defendant Jerald L. Kent ("Kent") was the President, Chief Executive Officer and director of Charter from July 1999 through the time of his resignation, which was effective as of September 28, 2001. Kent had previously served as Chief Financial Officer of Charter Investment, Inc., a predecessor to, and affiliate of, the Company. From 1979 to 1983 Kent worked in the Tax Division of Arthur Anderson.

28. Defendant Carl E. Vogel ("Vogel") became Charter's President and Chief Executive Officer, and a director of the Company, in October 2001.

29. Defendant Kent Kalkwarf ("Kalkwarf") was, during the Class Period, Executive Vice President and Chief Financial Officer ("CFO") of Charter. Kalkwarf was formerly a partner of defendant Arthur Andersen LLP. Defendant Kalkwarf has been indicted by the Grand Jury investigating Charter's misconduct.

30. Defendant David G. Barford ("Barford") was, during the Class Period, Executive Vice President and Chief Operating Officer of Charter. Defendant Barford has been

indicted by the Grand Jury investigating Charter's misconduct.

31. Defendant Paul E. Martin ("Martin") was, during the Class Period, Senior Vice President and Corporate Controller (Principal Accounting Officer).

32. Defendant David L. McCall ("McCall") was, during the Class Period, Senior Vice President of Operations for Charter's Eastern Division. In addition to his salary, McCall was a member of a partnership that received $177,600 in 2001 for office space leased to Charter. In addition, in 2001, Charter paid $571,533 to a construction company controlled by McCall's brother and $462,071 to a construction company controlled by McCall's son. Defendant McCall has been indicted by the Grand Jury investigating Charter's misconduct, and has entered a guilty plea.

33. Defendant William Shreffler ("Shreffler") was, during the Class Period, Senior Vice President of Operations for Charter's MidWest Division.

34. Defendant Chris Fenger ("Fenger") was, during a portion of the Class Period, Senior Vice President of operations for Charter's Western Division.

35. Defendant James H. Smith, III ("Smith") was, during a portion of the Class Period, Senior Vice-President of Operations in charge of Charter's Western Division. Defendant Smith has been indicted by the Grand Jury investigating Charter's misconduct.

36. Defendants Allen, Kent, Vogel, Kalkwarf, Barford, Martin, McCall, Shreffler, Fenger and Smith are sometimes referred to herein as the "Individual Defendants." Collectively with Charter, the Individual Defendants are referred to as the "Charter Related Defendants."

37. Defendant Scientific-Atlanta, Inc. ("Scientific-Atlanta") is based in Atlanta, Georgia, and is one of the nation's leading manufacturers of electronic equipment, including digital set-top boxes for use in the cable industry. A digital set-top box is equipment that is placed on a subscriber's television enabling it to receive and view digital television. Charter purchases this equipment and supplies them to its customers so they can view Charter's cable television programs.

38. Defendant Motorola, Inc. ("Motorola") is based in Schaumburg, Illinois, and is one of the nation's leading manufacturers of electronic equipment, including digital set-top boxes for use in the cable industry.

39. Defendant Arthur Andersen LLP ("Arthur Andersen") is an accounting firm headquartered in Chicago, Illinois, which served as Charter's independent auditor during the Class Period.

CLASS ACTION ALLEGATIONS

40. Lead Plaintiff brings this action as a class action pursuant to Rules 23(a) and 23(b)(3) of the Federal Rules of Civil Procedure, individually and on behalf of all persons or entities who purchased or acquired Charter common stock

during the Class Period and were damaged thereby, excluding the Defendants herein, their affiliates and any officers or directors of Charter or its affiliates, and any members of their immediate families and their heirs, successors and assigns (the Class).

41. The Class is so numerous that joinder of all the members of the Class is impracticable. Lead Plaintiff believes there are hundreds of record holders of the Company's common stock located throughout the United States.

42. Lead Plaintiff's claims are typical of the claims of absent Class members. Members of the Class have sustained damages arising out of Defendants' wrongful conduct in violation of the federal securities laws in the same way as Plaintiff sustained damages from the unlawful conduct.

43. Lead Plaintiff will fairly and adequately protect the interests of the Class. Lead Plaintiff has retained counsel competent and experienced in class action and securities litigation.

44. A class action is superior to other available methods for the fair and efficient adjudication of the controversy. The Class is numerous and geographically dispersed. It would be impracticable for each member of the Class to bring a separate action. The individual damages of any member of the Class may be relatively small when measured against the potential costs of bringing this action, and thus make the expense and burden of this litigation unjustifiable for individual actions. In this class action, the Court can determine the rights of all members of the Class with judicial

economy. Lead Plaintiff does not anticipate any difficulty in the management of this suit as a class action.

45. Common questions of law and fact exist as to all members of the Class and pre-dominate over any questions affecting solely individual members of the Class. These questions include, but are not limited to, the following:

a. whether defendants' conduct as alleged herein violated the federal securities laws;

b. whether the SEC filings, press releases and statements disseminated to the investing public during the Class Period misrepresented Charter's financial condition and results;

c. whether defendants acted knowingly or with deliberate recklessness in omitting and/or misrepresenting material facts;

d. whether the market price of Charter common stock during the Class Period was artificially inflated; and

e. whether the members of the Class have been damaged, and if so, what is the proper measure of damages.

46. Lead Plaintiff will rely, in part, upon the presumption of reliance established by the fraud-on-the-market doctrine in that:

a. defendants made public misrepresentations or failed to disclose material facts during the Class Period;

b. the omissions and misrepresentations were material;

c. the stock of the Company traded on the Nasdaq, an efficient market;

d. the market reacted to public information disseminated by the Company, and the Company was followed and reported on by various securities analysts;

e. the misrepresentations alleged would tend to induce a reasonable investor to misjudge the value of the Company's securities; and,

f. Lead Plaintiff and the members of the Class purchased their Company stock between the time the defendants or misrepresented material facts and the time the true facts were disclosed, without knowledge of the misrepresented facts.

SUBSTANTIVE ALLEGATIONS

BACKGROUND

Charter's Corporate Structure

47. During the Class Period, Charter was headquartered in St. Louis, Missouri, where all statements issued to investors were prepared and disseminated. Through 2000, Charter was divided into two operating "divisions," the Eastern and Western Divisions. Defendant McCall was the Senior Vice President of Operations for the Eastern Division.

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In 2001, the Western Division was divided into the (i) Midwest and (ii)Western Divisions, at which time it was headed by Senior Vice Presidents, defendants (i)William Shreffler and (ii) Chris Fenger and James Smith, III. Each of the Senior Vice Presidents for the Divisions were featured in Charter's Annual Reports. Within each of the Divisions there were several "Operating Regions," of which there were 10-12 altogether.

48. The Divisions, Regions, and individual offices of Charter were linked through two centralized computer systems, known as "Cable Data" and "CSG," that tracked all customer account and billing information.

49. Accounting personnel at Charter's Western Division office, located in Denver Colorado, collected and compiled financial data from the local and regional offices and forwarded the results to corporate accounting at Charter's headquarters in St. Louis. Defendant Kalkwarf, the Chief Financial Officer and defendant Martin, the Vice President of Accounting, supervised the final compilation of Charter's financial numbers in St. Louis.

The Importance of Operating Cash Flow EBITDA and Customer Growth in the Cable Industry

50. During the late 1990's, cable companies went through a period of significant capital investment and consolidation. Companies installed wire cable networks at significant expense, while also acquiring smaller companies. During this period, it was not unusual for cable companies' expenses to exceed revenues. For stock market analysts who

followed the industry, though, the short term losses were not important so long as the companies were building solid customer bases while sustaining a significant positive cash flow growth rate.

51. Critical to the assessment of the strength of a cable company's customer base was the degree to which it grew internally (rather than through acquisitions). Such growth indicated that customers were pleased with services and were not defecting. This became particularly critical as the cable companies faced stiff competition from satellite television companies, which did not rely upon costly underground wire cable systems.

52. "Operating cash flow" was also an important measure of cable companies' performance. Technically known as "EBITDA," operating cash flow was a commonly used alternative means of gauging the quality of a company's performance. Until recently, EBITDA was also perceived to be a more reliable measurement of the company's results, since it reflected the company's core operating costs during any period (rather than capital investments whose benefits would be realized over a longer time frame). Cable industry companies and analysts tended to use the terms EBITDA and "operating cash flow" interchangeably.

Generally Accepted Accounting Principles Applicable to Cable Companies

53. Given the significance assigned operating cash flow, it was critically important whether a company expensed certain costs, or capitalized them over a period of time (in

which case they were excluded from operating cash flow). Generally Accepted Accounting Principles ("GAAP") govern the accounting for such costs and the determination of whether they are expensed or capitalized.

54. Financial Accounting Standard ("FAS") 51 governs the standards for accounting on specific issues related to the cable industry. Among other things, FAS 51 states:

a. Labor costs associated with installing new services on the *first visit* to an address can be capitalized, and then depreciated over a period no longer than the period used to depreciate the cable television plant.

b. A portion of associated "indirect" costs, that are associated with installation or upgrade labor costs may likewise be capitalized.

c. The costs of subsequently disconnecting or reconnecting a subscriber (or an address) must be expensed. Thus, the second time a service is enabled at an address (even if it is a new subscriber), it must be expensed in the period incurred.

d. "Subscriber related costs" and general administration expenses must be expensed in the period incurred. These costs include:

> Cost of billing and collection, bad debts, mailings, repairs and maintenance of taps and connections, general and administrative systems costs such as salary of the system manager and office rent,

programming costs for additional channels used in the marketing effort or costs related to revenues from per channel or per program service, and direct selling costs.

Charter's Accounting Policies

55. Throughout the Class Period, Charter's *stated* accounting policy for expenses conformed to GAAP. That *stated* policy was:

> Costs capitalized as part of new *customer installations* include materials, subcontractors costs, internal direct labor costs, including service technicians and customer care representatives and internal overhead costs incurred to connect the customer to the plant from the time of installation scheduling through the time service is activated and functioning. We capitalize incremental and direct contract acquisition costs to the extent realizable from future revenues. The overhead rates established are based on a combination of internal company-wide overhead analysis and internal time and motion studies of specific activities. These studies are updated to adjust for changes in facts and circumstances. . . . The *costs* of *disconnecting and reconnecting* a customer are charged to expense in the period incurred. *Expenditures for repairs and maintenance* are charged to operating expense as incurred, while equipment replacements and betterments, including the replacement of drops, are capitalized. [Emphasis Supplied].

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56. While the Company's stated policy conformed to GAAP, in actual practice, as discussed below, the Company consistently violated its own policy and GAAP by arbitrarily capitalizing material portions of certain labor related expenses in order to artificially enhance its operating cash flow results in line with Wall Street's expectations. This dovetailed with Charter's fraudulent inflation of its internal customer growth rate, also detailed below.

57. The favorable, though fraudulent, results that Charter disseminated during the Class Period were intended to enable the Company to meet analysts' forecasts and thereby prop up the price of Charter stock. In turn, this enabled the Company to continue to use its stock as valuable currency on its acquisition spree. In 1999 and 2000 alone, Charter completed sixteen acquisitions. Such transactions include: (I) the acquisition of Bresnan Communications Company (involving cable systems in Michigan, Minnesota, Wisconsin and Nebraska) for approximately $3.1 billion, in which $1.0 billion in Company equity was utilized to finance such purchase price; (ii) a stock for stock merger with Cablevision of Michigan, Inc., a cable system in Kalamazoo, Michigan, in which Charter issued Class A common stock purportedly valued at approximately $170.6 million; and, (iii) the acquisition of several cable systems from Cable USA, Inc., and its affiliates for a total purchase price of $100.3 million, financing more than one-half of such purchase ($55.7 million) with the Company's Series A Convertible Redeemable Preferred Stock.

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THE FRAUDULENT SCHEME

58. Throughout the Class Period, defendants Kalkwarf and Barford were principally responsible for making sure that the Company met Wall Street's expectations, regardless of whether doing so reflected Charter's true operating and financial condition. These defendants instructed lower level personnel, including the senior operating officers of each division, to utilize certain fraudulent techniques to insure that the "numbers" were indeed "met." In order to accomplish these ends, defendants Kalkwarf and Barford instructed other personnel to inflate the customer counts and arbitrarily capitalize certain costs. In addition, as discussed below, defendants Kalkwarf and Barford engaged in kickback arrangements with Scientific-Atlanta and Motorola for the sole purpose of materially inflating Charter's revenue and operating cash flow.

Inflation of the Customer Counts and Internal Growth Rates

59. As discussed above, Charter touted its 2+% internal growth rate as being the best in the industry. To meet this rate, the Company had to annually add up to 140,000 new customers to its subscriber base by means other than purchasing other cable companies.

60. Analysts were enamored with the Company because of this growth rate. As a Credit Suisse analyst commented in a report issued on May 14, 2002: "Charter has historically been one of the fastest-growing cable MSO's owing to industry-leading basic sub[scriber] growth. . . ." It also meant

that Charter was successfully confronting the increased competition from satellite television companies.

61. This appearance of internal growth was a fraudulent illusion created by defendants to cover up the absence of any genuine internal customer growth. But for this scheme, Charter would have reported that the internal customer growth rate was flat, rather than 2+%. Plaintiffs' investigation indicates that this scheme was long-standing and grew exponentially throughout the Class Period. The Grand Jury charged that the *criminal* scheme to inflate subscribers commenced "in or about May 2001" when "it became clear to defendants that Charter would not reach its second quarter subscriber growth projections if its normal business practices for disconnecting customers were followed."

62. Pursuant to this scheme, defendants Kalkwarf and Barford instructed employees during weekly conference calls and in other communications to "manage" disconnects of customers in order to reach subscriber growth rate estimates projected by Wall Street analysts.

63. Among other things, Charter personnel inflated the customer count by the following fraudulent techniques:

a. Whenever a customer requested termination, or was otherwise 60 days or more behind in payments, the customer should have been disconnected and/or no longer counted in the subscriber base. In order to avoid the adverse impact this would have had on reported figures, Charter personnel routinely were told to "hold disconnects," that is, to not process the paperwork for the termination. Company-

wide, this amounted to over 100,000 customers during the Class Period. These terminations, if treated properly, would have wiped out all of the Company's reported internal customer growth rate.

b. At the beginning of the Class Period, the practice was to hold disconnects until after the close of the quarter, to enable Charter to make its numbers, and then to process the terminations. Each quarter's internal growth figures was materially inflated by the failure to exclude these customers who the Company knew were no longer paying for the service. As the Class Period progressed, the period for holding disconnects was extended beyond the end of one quarter, and cumulatively expanded.

c. Charter personnel were also instructed to hold the disconnects of customers who had been given 3-6 months of free trial service, but had refused to pay after the end of the trial period. Nonetheless, during the free trial period, Charter assigned a nominal fee to these accounts in order to include them as paying subscribers, even though the Company did not generate a bill for these accounts and did not receive any revenue from them.

d. Charter personnel were instructed to routinely double-count customers if they (I) moved from one location to the next (counting both their prior and new location); (ii) upgraded their account (counting the old service and the additional service separately); and/or (iii) reactivated service (counting the prior service and the reactivated service separately).

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e. Charter personnel were instructed to routinely misclassify its cable customers in order to paint a false picture of internal growth. Charter offered customers its basic cable package, or alternatively, just access to the Internet (data access, or digital-only customers). The former were much more desirable, since charges for the basic package were considerably higher than Internet access only. Charter thus routinely: (i) included 50% of the monthly fee paid by digital-service-only customers in the basic cable revenues; and, (ii) included such digital-only customers in the total count of the basic cable customers. This enhanced the false appearance of the Company's customer growth rate.

f. As further evidence of the fraudulent nature of this over counting scheme, Charter offices routinely maintained two sets of books regarding customer counts: (I) the first set included the inflated numbers, which incorporated "holds" on disconnects and other devices which overstated Charter's true subscriber count (but reached the "quota" assigned to that office), and were passed on to corporate headquarters; and, (ii) the second set, which contained the actual, lower numbers, which were utilized to calculate employee bonuses.

g. By way of example, during the period 1999 through 2002, Charter's offices in Georgia actively engaged in hold disconnects practices. Sometimes customers were disconnected in the field, but the disconnect was not processed in the Company's billing system. Other times, customers were not even disconnected in the field. Such disconnects were held until the local office turned in its subscriber count and financial reports to the regional offices

at the end of each quarter, after which the disconnects were processed.

64. Even though customers slated for disconnection were not paying, or had requested termination, Charter continued to routinely bill them. To avoid complaints from customers who had requested termination, but whose disconnects were subject to "holds," Charter resorted to issuing bills to these customers but changing the mailing address to Charter's own offices. This enabled the Company to record the customers as active (and record their bills as payable). Such examples include:

a. Starting in July 2001, Charter's General Manager in Columbia, Tennessee, Don Grammar, following instructions that were received from headquarters, ordered his office to generate and mail out phony bills for terminated customers (as it had previously), but to change the addresses on such bills to Charter's *own* office instead of the customer. In some cases, the bills and envelopes were also addressed "ATTN DON," reflecting the name of the General Manager.

b. When an employee in the Columbia, Tennessee office raised questions about the legality of the inflated subscriber counts, she was told by the General Manager's administrative assistant that *corporate headquarters* was ordering all of its offices to delay processing the disconnects. Copies of such bills are attached.

65. Some offices took the fraudulent invoices process one step further, and created fictitious accounts with invoices mailed to Charter offices. For example:

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a. In its Duluth, Georgia offices, a senior officer instructed customer service representatives to create such phony billings, have them mailed out to a Charter address so that they would be returned to Charter, and locked in the filing cabinet in his office. Fictitious customer names, such as "Jack Daniels" and "Dale Earnhardt," were utilized in such a scheme.

b. False subscriber accounts were also created at Charter's Stockbridge, Georgia offices at the direction of Phil Skinner, the General Manager and Director of Operations for Charter's Southern Region.

66. Several Charter employees, including defendants McCall and Smith, raised objections to the practice of holding disconnects in order to meet projected subscriber numbers. Nonetheless, defendant Barford insisted that employees hold the disconnects in order to make the numbers. Despite their objections, Smith and McCall relayed these instructions to subordinates knowing that this would results in Charter publicly reporting materially inflated subscriber counts.

67. Charter made sure that its employees knew that this was the way the Company did business by quickly terminating any lower level personnel who questioned or complained about the policy:

a. When employees in the Maryville, Illinois office questioned these practices at a meeting in late 2001 or early 2002, they were threatened by the head of Human Resources with the loss of their jobs and the loss of any severance if they made any public disclosures of the above-described practices.

b. Some of these terminations involved generous severance packages that sought to preclude anyone from discussing the Company's illegal business practices with anyone. William Reilly (Charter's finance director for Georgia) was the beneficiary of such a package.

68. Other specific examples of instances where disconnects were delayed beyond the end of quarters so that Charter could "make its numbers" during 2001 include:

a. In weekly conference calls, Kalkwarf and Barford directed other Charter officers to inflate subscriber growth rates in order to meet internal and analysts' projections.

b. In response to these directives, defendant McCall, Vice President of Operations for the Eastern Region, specifically ordered Regional Directors in Georgia (Phillip Skinner, William Reilly and Michael Davolt) to hold disconnects until after the end of quarters. At the hearing on July 25, 2003 where he entered his plea of guilty to the indictment, defendant McCall admitted that he was "instructed to meet certain quarterly expectations" about the number of subscribers, and further acknowledged that the scheme involved "a lot of people in the company."

c. In response to these directives, defendant Smith likewise ordered personnel to hold disconnects until the end of quarter during 2001. At a meeting that took place on September 14, 2001, that was attended by numerous Charter executives, defendants Barford and Kalkwarf presented information that Charter had, at the time, 60,000 to 90,000 "managed" disconnects, i.e., customers who had not paid

their bills or had voluntarily terminated their accounts, and were due to be cut-off, but were not in order to enable Charter to make its subscriber count growth rate numbers.

d. On or about October 5, 2001, defendant Barford e-mailed employees at Charter's divisions instructing them to provide "basic net gain in 4Q to get to 1% and 1.4% growth rate for the year." Consistent with his plan to maintain a reserve of disconnects that could be used in the future to continue managing the subscriber count growth rate, Barford added, "[Then] tell me how many managed disconnects you would still have left over after getting to these numbers."

e. In response to these directives, in October 2001, defendant Shreffler, Vice President of Operations for the Mid-West Division, ordered all disconnects that were being processed in the field not to be processed in the data system. These instructions were conveyed throughout the Division to Charter's offices such as that in Maryville, Illinois (where Charter had been founded in 1993), with the instructions "complete it in the field, but hold the paperwork."

f. Consistent with Barford's October 4, 2001 directive, throughout the fourth quarter of 2001, the Maryville, Illinois system alone had approximately 2,400 customers who had either requested disconnects or had already been physically disconnected, but who were still being counted in the Company's subscriber base. This number can be verified by reviewing the "no truck" data reports in the CableData system during and immediately after the period. Indicative of the degree to which this practice inflated the reported subscriber growth rates, there were 50,000 total

customers for the entire Maryville region. Thus, the amount of disconnects still counted as active customers totaled nearly 5%, which was over twice the reported internal customer growth rate for the entire Company.

g. Other Charter divisions likewise followed Barford's directive. In October, 2001, defendant Fenger, the Senior Vice President of Operations for Charter's Western Division, specifically ordered that the processing of all disconnects be halted for the remainder of the year. Fenger did so with the knowledge of, and indeed in response to, discussions with Kenneth Rhodes, a senior officer in Charter's management.

h. This directive was consistent with the policy Fenger had been enforcing for several years. When previously questioned by a district director of operations about this disconnect policy, Fenger bluntly replied "that's just how we do business."

i. On December 6, 2001, Barford e-mailed Kalkwarf and another senior Charter executive advising that "Basic [i.e. internal] growth for December should be over 60K holding discos."

j. In December 2001, an outside contractor for Charter (Cabletex) was specifically instructed to hold the 3,300 disconnects that were scheduled to be performed in the Dallas-Fort Worth market until after the close of the quarters. On another occasion, Charter personnel instructed Cabletex to hold any disconnects until after a shareholder's meeting.

k. The specific directive to hold disconnects in the Long Beach, California office in order to artificially boost subscriber counts came from the Senior Vice President for that Region and was consistent with what was happening throughout all of Charter's local and regional offices, as directed by corporate headquarters.

69. As 2001 drew to a close, Charter executives began discussing an exit strategy from this scheme, fully aware that the Company would have to purge from its rolls those customers who should have been written off long ago.

70. On December 7, 2001, Barford e-mailed Kalkwarf and stated: "We are trying to figure out how many we could disconnect in December and still be in line with others. Is .5% or .6% sellable without revising downward [guidance]."

71. In a December 2001 memo to defendant Barford, defendant Kalkwarf suggested that Charter might "bleed the disconnects in over time" or "take the hit in the first quarter on the call for the change in strategy." Kalkwarf concluded by stating: "We should still take a hit (140,000 customers times $3600 per customer is just under $1 per share) but at least we are running the business and we can argue that we did end the year at approximately 1%."

72. Shortly after, on December 10, 2001 Kalkwarf e-mailed Barford and a senior Charter executive urging that they "stick with original plan to get 61,000 net gain for December" which would "help us get revenue and cash flow for the year. . . ." In another e-mail of the same day, Kalkwarf further urged that:

> My thoughts are to discuss the issue in the first quarter of next year as we are going to take a hit for it no matter what and if we have 0 or negative growth this year after our statements of last week and earlier we will take two hits–one for customer growth and one for continued lack of [credibility].

73. The exit strategy was sealed in a December 21, 2001 e-mail by defendant Barford to defendant Kalkwarf and a senior Charter executive stating, "I want to give the field direction to dump all the voluntary and 120 day or greater nonpays right after cut [for the year end 2001]. . . ."

74. Charter personnel also sought to cover-up evidence of illegal practices immediately following the decision in early 2002 to write off over 125,000 accounts for which disconnects were on "hold." In Charter's offices in Duluth, Georgia, employees were instructed by Harold Collins, the Vice President and director of finance for the Georgia region, to shred financial documents and e-mails going back to 1998. Employees were told by another senior person in the office, Mark Marshall, that if they were asked about the practice of creating false bills "don't say anything."

Charter's Blatantly Improper Capitalization of Labor Costs, Overhead and Administrative Expenses

75. In addition to chronically inflating subscriber counts and revenues, defendants also distorted Charter's performance and profitability by improperly capitalizing certain costs (particularly labor costs) that should have been expensed, thereby materially inflating the Company's critical

operating cash flow results. The purpose of this scheme was to create the illusion that, just as the Company's subscriber base was growing, so too were its earnings from such subscribers, as measured by operating cash flow/EBITDA.

76. But for this scheme, Charter's reported rate of operating cash flow growth would have been 6% for 2001 compared to 2000, rather than the 12.5% reported. The operating cash flow growth rate was also materially inflated for years 1999 and 2000.

77. The directives to capitalize portions of labor costs that GAAP required to be expensed originated with defendants Kalkwarf and Barford, who used Division and Regional officers to communicate the need to increase the rate of capitalization in order to avoid expected shortfalls in operating cash flow. As the Vice President of the Northeast Region wrote in a memorandum sent to all its offices during the Class Period, 35% of the salaries of customer service representatives had to be capitalized (rather than properly expensed) because the Company was "behind on the numbers."

78. Charter's widespread practice of capitalizing labor costs that should have been expensed not only violated GAAP as detailed in ¶¶ 53 - 54, *supra*, but was inconsistent with its own policy as set forth in its public filings, particularly the portion related to repair and disconnection related expenses:

> The costs of disconnecting a customer are charged to expense in the period incurred. Expenditures for repairs and maintenance are charged to

operating expense as incurred, while equipment replacement and betterments are capitalized (*See* ¶ 55, *supra*.)

79. Charter's improper labor capitalization practices were applied to several areas:

a. Virtually all labor-related costs were capitalized to some degree depending on the amount needed to make up the expected operating cash flow shortfall, even though GAAP only permitted capitalization of new customer installation costs.

b. Charter arbitrarily capitalized a significant portion of certain technician labor costs associated with (i) customer upgrades to digital service; (ii) repairs on installation; and, (iii) changes to splitters (devices in the home that divides a signal into multiple paths), when all such costs should have been expensed.

c. Charter routinely capitalized significant portions of the salaries related to customer service representatives, and large portions of management salaries as well. Both of those types of costs should have been expensed.

d. Charter routinely capitalized significant portions of "reconnect" costs (reconnecting subscribers who had requested that their cable be disconnected or whose service had been terminated for failure to pay their bills). The percentage of capitalization changed from month to month, depending on the amount of savings needed to meet cash flow expectations. In the Duluth, Georgia office, 75% of these costs were capitalized during the Class Period.

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e. These improperly capitalized costs totaled $93 million in 2001 and $52 million in 2000.

f. In order to further improperly capitalize costs, the Company also had outside contractors directly pay distributors for supplies and similar items, and then had the contractors include the costs of such goods in the bill for contractors' services. Charter then capitalized the entire cost as "outside contracting," when in fact the items paid for by the contractors were strictly for Charter's use and should have been expensed.

g. At the direction of regional officers, including John McFerron, the Regional Vice President of Finance for Charter's North Central region (based in Madison, Wisconsin), Charter offices also improperly capitalized 100% of the labor costs associated with its Internet Division. Offices compounded this inflation by shifting additional employees into the Internet division to maximize the capitalization of labor costs.

h. Charter also paid third-party contractors to conduct marketing campaigns. The Company improperly deferred the cost of these services rather than expensing them as incurred. As a result, $59 million in marketing campaign expenses were improperly deferred rather than expensed in 2001. Such accounting for marketing campaigns was in direct violation of Statement of Position 93-7 ("SOP 93-7"), *Reporting on Advertising Costs*, which governs the accounting for advertising costs under GAAP. SOP 93-7 states the following:

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The costs of advertising should be expensed either as incurred or the first time advertising takes place except for:

a. Direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits (future benefits). Examples of the first time advertising taking place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.

b. Expenditures for advertising costs that are made subsequent to recognizing revenues related to those costs.

80. Charter not only improperly capitalized the direct labor costs described above, but also improperly capitalized allegedly associated general and administrative overhead expenses. By way of example, John McFerron ordered that 47% of all general and administrative expenses be capitalized.

81. These percentages of labor and other costs that were capitalized were unrelated to the amount of time or portion of expenditures that were appropriately spent on customer implementation related services, but instead related strictly to the amount of the operating cash flow shortfall that Charter personnel were instructed to cover.

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82. As a result of this scheme, the amount of purportedly related overhead and administration costs that Charter capitalized per subscriber was nearly twice that of Charter's competitors.

83. While much of the implementation of the improper capitalization was done at the local level, a significant portion was also performed at a centralized location, in Charter's Denver, Colorado offices, where all the Company's regional and divisional reports were consolidated. Accounting personnel in this office were instructed to "skew the numbers" by moving costs from one account code (which was to be expensed) to another code (which was to be capitalized) in order to make up any cash flow shortfalls.

84. In addition, accountants in Charter's Denver offices also artificially kept down the Company's expenses by directing the regional offices to hold payments due for contract labor at the end of each quarter until the following quarter, or even later. By the end of 2001, for example, Crown Fiber, one of the Company's largest outside contractors, was owed approximately $5 million by Charter. Charter avoided recognizing this expense by deferring the payment and not recording any account payable.

85. Finally, Charter also improperly capitalized certain promotional costs for new programs which should have been expensed in the year incurred.

86. As a result of this improper capitalization of expenses, Charter's reported operating cash flow was materially overstated by at least $146 million in 2001, and by $87 million in 2000.

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Manipulation of Revenues

87. In order to maintain the illusion of internal customer growth, Charter also had to show revenue growth consistent with such inflated customer counts. This was accomplished by manipulating the Company's centralized billing system. Under its own revenue recognition policies, Charter's monthly numbers were supposed to represent sales made from the 21st day of the month to the 21st day of the following month. Bills had to be mailed by the 21st of the month to have their charges booked as revenue for the month.

88. Billing results for those offices using the CSG billing system (which were only a small percentage) reflected the amount of bills actually sent by the 21st of each month (because the system had a hard-coded month-end cut-off date set for the 21st of each month). However, the vast majority of the Company's offices, those using the Cable Data billing system, had their closing extended to the 1st or 2nd day of the following month unless it was the end of the quarter, in which case Charter headquarters extended the billing cut-off date for regional offices by four or five days.

89. Charter also inflated its revenues by including all new program "launch fees" paid by suppliers at the outset of program contract period, rather than amortizing such fees over the entire term of the contract.

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Charter Entered into Sham Arrangements with Defendants Scientific-Atlanta and Motorola Intended To Artificially Boost Charter's Revenues and Operating Cash Flow

90. By way of background, in order to provide digital cable television service, it was necessary for Charter to purchase digital cable converter boxes for installation in customers' homes. Purchases of these digital cable converter boxes became a large capital expense for Charter, and made Charter important customers of defendants Scientific-Atlanta and Motorola, the nation's two largest manufacturers of such converter boxes and other equipment used by cable companies.

91. In August, 2000, defendants Kalkwarf and Barford realized that the Company was facing a year-end short fall **of $15 to $20 million** in operating cash flow relative to amounts projected by Charter and those analysts who covered the Company. In order to help cover that shortfall, the Company entered into sham agreements for "advertising" from defendants Scientific-Atlanta and Motorola to inflate Charter's operating cash flow for the fourth quarter of 2000. **In fact, neither Scientific-Atlanta, Motorola, nor any other set top box vendor had ever entered into any spot telecasting agreement with Charter prior to these sham transactions.**

92. In order to cover this shortfall, Kalkwarf and Barford instructed John Pietri ("Pietri"), Charter's Senior Vice-President of Engineering, to approach Scientific Atlanta and Motorola, and urge them to purchase advertising from Charter. Both Scientific-Atlanta and Motorola initially declined during August 2000.

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93. In order to entice both vendors to join the scheme to inflate Charter's cash flow, as detailed below, the Company then proposed that the vendors engage in a series of "wash transactions" that had no economic impact but gave all participants the appearance of increased revenues.

94. As of August 2000, Charter had pre-existing agreements with Scientific-Atlanta and Motorola to purchase a certain number of set top boxes over a specific amount time at agreed upon prices. Motorola's set top box agreement with Charter had begun in 1998, when Motorola and Charter entered into a "mega deal" agreement for the purchase of set top boxes. Subsequently, on December 2, 1999, Pietri had signed a letter of intent to purchase digital set top terminals from Motorola for the first and second quarters of 2000. Subsequently, on December 7, 1999, Jeffrey Pierce, Director of National Accounts of General Instrument (a division of Motorola) and Pietri signed another agreement whereby Charter was released from the commitment in the 1998 "mega deal," with a future commitment by Charter to purchase 1 million digital set top terminals and 75,000 cable modems through 2000 and 2001 calender years. The additional digital set tops would be purchased pursuant to the pricing in the 1998 mega deal agreement. The agreement provided that any modification to the schedule had to be signed off by Pietri for Charter, and David Robinson, Vice-President and General Manager of General Instrument's Digital Network Systems.

95. Similar to the agreements between Motorola and Charter, Scientific-Atlanta and Charter also had a set top box agreement in effect prior to August 2000, pursuant

to a December 10, 1999 agreement, which was modified on May 4, 2000. The agreement was executed by Steve Kaufman, the National Business Manager of Scientific-Atlanta, and Pietri. Under this agreement, Charter was obliged to purchase 300,000 set tops from May 2000 through the end of the year, at pricing that was set forth in the December 10, 1999 agreement. Charter was also required to purchase modems and additional 1,000,000 set tops in 2001 and 2002. Charter was required to purchase at least 20,000 sets per month, but no more than 60,000 per month for those 8 months.

96. Subsequently, on July 13, 2000, Charter agreed to purchase an additional 150,000 set tops from Scientific-Atlanta prior to December 31, 2000, over and above the 300,000 that the May 4, 2000 agreement provided for. This agreement was again executed by Steve Kaufman and Pietri.

97. These prior agreements; however, were abandoned in order to pursue the fraudulent scheme. After Scientific-Atlanta and Motorola expressly declined to purchase advertising from Charter, Pietri (on orders from his superiors) proposed that Charter pay Scientific-Atlanta and Motorola an additional $20 for each digital terminal on all outstanding and future purchases through the end of 2000, despite pre-existing contracts, so long as the suppliers kicked back that same amount to Charter in the form of "advertising" or "marketing support payments" during the fourth quarter of 2000. Thus, the $20 price increase to be paid by Charter, and the "advertising" payments kicked back by the vendors, would offset each other and have no economic substance.

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98. Pietri, on behalf of Charter, Tom Nilson, Managing Director of North American Sales and Steve Kaufman of Scientific-Atlanta, as well as Jeffrey Pierce from Motorola, agreed to engage in these sham transactions, even though they knew that there was no real economic benefit to either company. However, such increased payments would increase the vendors reported revenues. The vendors also knew that Charter would be inflating its OCF by treating the payments for advertising as current period revenues, but capitalizing the increased payments for the equipment, and thus spreading out the payments over the life of the equipment, since that was how such equipment was usually booked by customers.

99. These Vendors knew full well that under Generally Accepted Accounting Principals ("GAAP"), purchases of equipment such as the set top boxes were generally capitalized over the life of the equipment, while revenues from advertising sales were generally recognized immediately.

100. Once Scientific-Atlanta and Motorola agreed to participate in the scheme, the vendors and Charter set about crafting the necessary documentation to support the fraudulent and fictitious transactions. The parties to the scheme knew that if there was a linkage in the documentation or timing of the price increase and advertising purchase, the accountants would treat the transactions as a wash, and neither side would benefit. In order to deceive the auditors and the public, on August 28, 2000, Pietri e-mailed Tom Nilson telling him that Scientific-Atlanta needed to send Charter a letter notifying Charter of a price increase in the set top boxes. Pietri told Nilson the following:

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Tom,

The pricing increase notification letter should include three major points:

1. The reason for the price increase and the date (09/01/00) of the increase.

2. A description of the quantities of set-tops this letter would cover (the anticipated number of set-tops (351,180) that SA expects to ship and Charter expects to take delivery of between 09/01/00 and 12/31/00.

3. A penalty provision in case Charter doesn't accept the anticipated number of set-tops in the specified time frame.

In addition, I will be sending the advertising contract for review prior to the final particulars being worked out. I am trying to get an electronic version of it for this review. Hope this helps.

John

101. Pietri then sent an internal e-mail to Wes Hart, Charter's Vice-President of Advertising Sales, copying defendant Barford and other marketing personnel, directing that the Company should draft advertising contracts totaling $10,812,560 for Motorola, and $6,823,080 for Scientific-Atlanta (the final contract ended

up at $6,730,000). These amounts corresponded exactly to the shortfall Barford and Kalkwarf sought to cover.

102. In furtherance of the scheme, pursuant to Pietri's e-mail to Tom Nilson, on August 31, 2000, Scientific-Atlanta responded with documentation signed by both Steve Kaufman and Pietri claiming that because of increased costs in manufacturing, Scientific-Atlanta was imposing price increases for digital converter boxes scheduled to be purchased by Charter for the balance of the year. Scientific Atlanta knew that this was a lie. There was no price increase for any other Scientific Atlanta customers at the time. Moreover, Scientific-Atlanta and Charter had previously entered into a "most favored customer" contract establishing a set price for each converter box back in 1999 and in May 2000. The only purpose of the increase was to fund the payment for the $6,730,000 spot telecasting contract between Charter and Scientific-Atlanta that had been agreed on but not yet executed.

103. Motorola and Charter engaged in similar fraudulent transactions. On August 31, 2000, the same day as the purported "increase" in price for the Scientific-Atlanta boxes, Jeffrey Pierce of Motorola and Pietri signed a contract whereby Charter agreed to purchase 540,000 set top boxes between 9/1/00 and 12/31/00. Charter further agreed to pay Motorola $20 liquidated damages for each unit that Charter *failed to* purchase during that 4 month time frame.

104. Motorola knew that this agreement was blatantly fraudulent. In fact, Charter already had an agreement with Motorola whereby it would purchase the

540,000 set top boxes in 2001 (as part of the updated 1998 mega deal.) There was clearly no benefit to Charter to suddenly accelerate its purchases of these set top boxes, particularly since to pay full price, it would have to come up with an additional $140 million (which Motorola knew from review of Charter's own public financial statements, was far more cash than the company had on hand.) Clearly, the contract was entered into with the expectation that Charter would *not* seek delivery of the additional set top boxes, and would then have to pay Motorola the $20 per set not ordered.

105. Indeed, it is no coincidence, but rather further indicative of Motorola's ffraudulent intent, that the precise amount that Charter agreed to pay for all these sets that it wasn't going to order equaled the amount that Motorola agreed to pay Charter for alleged advertising; 540,000 times $20 equals $10,800,000.

106. In September, 2000, Scientific-Atlanta and Motorola drafted and entered into separate written agreements with Charter for the marketing support payments entitled "Spot Telecasting and Digital Marketing Support Fee Agreements." The terms of the agreements purported to cover part of Charter's *cost* for promotional advertisements for Motorola and Scientific-Atlanta equipment. However, Motorola and Scientific-Atlanta agreed to pay 4-5 times more for their advertising time slots than other parties had paid Charter for advertising time slots during 2000. Scientific Atlanta and Motorola knew that they were being charged excessive rates, since these companies engaged in their own advertising campaigns. These defendants had no incentive

to challenge the rates since they knew the transactions were shams, solely constructed to give each side the appearance of greater growth.

107. The spot telecast contracts were executed on September 15, 2000 by Pietri and September 21, 2000 by Scientific-Atlanta; and on September 29, 2000 by David Robinson of General Instrument and October 2, 2000 by Pietri. The wash transaction consisted of two sides–the advertising agreement signed by Charter and Scientific-Atlanta at the end of September for $6,730,000, and the 8/31/00 letter agreement increasing costs by $6,730,000,with no real economic benefit for Scientific-Atlanta or Charter. Similar, Motorola's increase in set top boxes on August 31, 2000 equaled the spot telecast contract, $10,800,000, signed off on at the end of September.

108. As a result of this scheme, Charter was able inflate its reported operating cash flow by more that $17.5 million in the fourth quarter of 2000, thereby meeting analysts expectations and further buoying Charter stock.

109. The Vendor Defendants deliberately entered into these fictitious transactions without knowing full well that Charter intended to utilize the revenue to boost its reported results. Indeed, the Vendors themselves were likewise able to boost their reported revenues, despite clearly the "wash" nature of the transactions.

110. The subsequent indictment of Kalkwarf and Barford further charged that the "although the set-top box price increase contracts were not finalized with either vendor until late September, the contracts were both

backdated to late August giving the false appearance that the set-top box price increase agreements were negotiated a month before the advertising contracts which were dated in late September." Such backdating is further indicative of the vendor defendants' scienter and complicity in efforts to mislead Charter's auditors.

111. Further indicative of their fraudulent state of mind, Motorola and Scientific-Atlanta also engaged in a similar scheme with another cable television provider, Adelphia Communications ("Adelphia"), shortly after they engaged in the Charter transactions. Indeed, as revealed in testimony during the subsequent criminal trial of Adelphia principals, the proposed deals between that cable company and the vendor defendants were characterized "Charter like."

112. As with Charter, in or about October 2000, Scientific-Atlanta sent Adelphia the same fraudulent letter regarding a purported price increase, though this time the amount was $31.00 instead of $20.00 per set. The increased payments for the sets were then kicked back to Adelphia in the form of advertising. Motorola entered into similar arrangements with Adelphia. The sham transactions with Adelphia inflated its reported cash flow by over $100 million.

113. The SEC found that Charter's wash transactions with the vendor defendants were in violation of the Federal Securities Laws. In its July 27, 2004 Cease and Desist Order against Charter , the SEC specifically found that;

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In the fourth quarter of 2000, Charter also inflated its year-end revenue and operating cash flow by $17 million when it realized its year-end revenue and operating cash flow for 2000 was going to be short of analysts' expectations. To do so, Charter entered into one contract under which it agreed to pay two of its digital set-top box suppliers an additional $20 for each set-top box it purchased and simultaneously entered into another contract under which its set-top box suppliers agreed to purchase $20 in advertising services from Charter for each set-top box Charter purchased. In realty, no real revenue was generated from these transactions because Charter provided the suppliers with the money they used to purchase the advertising services from Charter. Charter overpaid approximately $17 million to the two set-top box suppliers and received the same amount back from the two suppliers as advertising revenue in the fourth quarter of 2000. Consequently, Charter improperly inflated its 2000 year-end revenue and operating cash flow that it reported to the Commission and to the public in its Form 10-K for 2000.

114. The SEC further found that "these transactions were not undertaken at fair value of the time slots purchased because these set-top box suppliers paid four to five times more for their advertisement time slots than other parties had paid Charter for advertisement time slots during 2000." The SEC concluded that the contracts were executed to carry out the scheme to raise additional revenue and OCF.

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Defendants' Direct Participation in and Knowledge of the Fraud

115. Defendants Kalkwarf and Barford were directly involved in orchestrating directives in the Company to ensure that Wall Street estimates were met, and negotiating the sham transactions with Scientific-Atlanta and Motorola. They were fired because of their involvement in the fraudulent scheme. They have since been indicted by the Grand Jury.

116. Defendant McCall, Senior Vice President for the Eastern Division, was also actively involved in implementing the "hold disconnects" practice. An e-mail from Josh Jamison, one of the Regional Vice Presidents, to employees in the Massachusetts region, requiring that the Company hold all disconnects under 90 days past due, resulted from a meeting between defendant McCall and Jamison. In his Plea Agreement dated July 25, 2003, defendant McCall admitted he was directed to hold or postpone disconnects in order to "meet the forecasted numbers" for the subscriber growth rates that Charter had publicly projected for the second, third and fourth quarters of 2001. McCall further admitted in his Plea Agreement that in response to these directives, he:

> a. [G]ave instructions to hold disconnects to each of the regional vice presidents working below him. Soon after the end of the second, third and fourth quarters of 2001, these held disconnects would then be disconnected or "cleaned-up."

b. [K]new that the purpose of holding these disconnects before the end of the quarter and then cleaning up disconnects afterward was to inflate Charter's quarterly growth in subscriber numbers that were intended to be reported to the public. During these quarters, without the holding of disconnects, Charter would not have been able to meet its quarterly subscriber forecasts.

117. Defendant Smith has been indicted by the Grand Jury for instructing subordinates to hold disconnects during the second, third and fourth quarters of 2001 "knowing that these instruction would result in Charter reporting inflated subscriber numbers to the investing public."

118. In response to the directives received from Charter's corporate senior officers, the senior officers of Charter's two (and subsequently three) Divisions informed regional personnel of the steps to be taken to ensure those numbers were met. By way of example, defendant Shreffler, the Senior Vice President of Operations for the MidWest Division told his assembled staff at an "all employee" breakfast held on May 23, 2001, that he was brought in to bring the numbers up: "whatever it takes to get the numbers up . . . It will happen no matter what, no matter what it takes."

119. Defendant Shreffler directed all of his system managers to ensure that there would be "no disconnects" at the end of the quarters and when shareholder meetings were scheduled. This was intended to create the appearance that the Company's subscriber base was healthy and growing.

Shreffler's employees were instructed to keep track of the disconnects by maintaining a handwritten list, so as to avoid any record of actual or pending disconnects in the computerized billing system. In October, 2001, defendant Shreffler ordered that all disconnects were not to be processed in the system.

120. Defendant Shreffler had worked his way up the ranks at Charter (initially in Denver and Minnesota regional offices) utilizing these same techniques, and was rewarded by senior corporate officials until he rose to head one of the Company's three divisions. Defendant Shreffler, known as "Coach" by his subordinates, accepted nothing less than the goals or quotas that were set by corporate headquarters, refusing to accept numbers that fell short and telling employees to "make it work."

121. Consequently, when a customer service manager in the Central Division was asked by another employee why he was changing subscriber numbers, he replied that he wasn't going to give "Coach" numbers that he didn't like, and was "making the stockholders happy." This was consistent with Shreffler's own practices. When he became Senior Vice President of the Central Division in the middle of 1999, the accurate count of subscribers was reported to him on a daily basis. If he did not like the numbers, he ordered them changed. This was done by entries into the centralized data system, CableData or CSG.

122. In October, 2001, defendant Fenger ordered all disconnects to be held until after the close of the year.

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123. Defendants Allen, Kent and Barford were otherwise alerted to Charter's practice of holding disconnects by a certified mail letter dated April 19, 2001, from a Marketing Manager at Charter's Long Beach, California office, in which he asserted that he had been fired on the pretext of groundless sexual harassment charges made against him, when in fact the real reason for his termination was because he was "questioning the over 2000 disconnects that were pending at the time." No response was ever received, although the "whistle blowing" employee did receive confirmation of receipt of such letter. On information and belief, defendant Kent was also at the September 14, 2001 meeting that, as described in the Grand Jury's Indictment, was "attended by numerous Charter executives' at which defendants "Barford and Kalkwarf presented information that Charter had between 60,000 and 90,000 managed disconnects."

124. Defendant Allen, as Chairman and controlling shareholder of Charter was responsible for creating the culture at the Company that accepted nothing less than meeting the numbers to "keep shareholders happy." Allen knew that the appearance of customer and operating cash flow growth was essential in securing additional financing that was critical to his plan to build a cable empire. He demanded that Charter officers meet these goals and recklessly turned a blind eye to this misconduct. Indeed, when Kent signaled in September 2001 that the customer growth rate might decline, Allen promptly fired him.

125. Defendant Vogel, Charter's President after defendant Kent's departure in September 2001, was aware of the true reasons for the write-off of over 120,000 customers

that Charter announced on February 11, 2002, but deliberately mischaracterized those reasons in order to divert attention from the Company's prior fraudulent misconduct. *See* ¶ 181 (a)-(c)), *infra*.

126. The Individual Defendants were otherwise aware of, or recklessly disregarded, the fraudulent scheme by virtue of their positions as senior operating and financial personnel in the Company.

DEFENDANTS' MISLEADING PUBLIC STATEMENTS AND MATERIAL OMISSIONS DURING THE CLASS PERIOD

The Misleading Nature Of The Statements

127. As detailed below, throughout the Class Period, Charter portrayed itself as a company with "organic" or "internal" growth of subscribers; apart from its numerous acquisitions of other cable companies. The Company also touted its operating cash flow growth rate and revenue growth. As detailed in the foregoing ¶¶ 58-114, *supra*, such statements were materially false and misleading, for the reasons summarized below:

a. Charter's internal growth rate for subscribers was artificially and materially inflated as a result of the fraudulent scheme described above.

b. But for the fraudulent subscriber scheme, the Company would not have been able to boast that it was the industry leader "in generating internal growth." Indeed, as a

result of the scheme, the Company would have experienced no growth of its basic video cable subscribers during two years of the Class Period.

c. Charter also materially inflated its operating cash flow/EBITDA by: (i) improperly recognizing program launch fees at the outset of the contract rather than over the entire term of the contract; (ii) failing to write off customers and related account receivables on a timely basis; and, (iii) improperly capitalizing labor and other costs related to the servicing and termination of accounts and other general and administrative overhead expenses, that GAAP and the Company's own accounting policies required to be expensed.

d. But for such improper accounting, Charter would not have been able to boast that its operating cash flow rate was "twice that of any other cable operator." In fact, Charter's 2001 EBITDA growth rate would have been half the amount reported.

e. As a result of the foregoing schemes, Charter's reported financial results, including revenues, expenses, and operating cash flow/EBITDA, were materially misstated throughout the Class Period, causing the price of Charter stock to be artificially inflated.

The Statements

128. Charter's Initial Public Offering commenced on November 8, 1999, and the sale to the public of the 170,00,000 shares of common stock at $19.00 per share raised approximately $3.23 billion. The November 4, 1999

Registration Statement and Prospectus represented in connection with the offering stated, among other things, that for the six months ended June 30, 1999, Charter had $594 million in revenues, with over $237 million in EBITDA. The IPO offering materials also represented that the Company was currently serving 3.7 million customers, and that an additional 2.5 million would be added through acquisitions. In its Registration Statement and Prospectus, Charter represented that its "internal customer growth" in 1998, without giving effect to the cable systems it acquired that year, "was 4.8%, more than twice the national industry average of 1.7%." The Registration Statement was signed by defendants Allen, Kent and Kalkwarf.

129. The statements regarding Charter's cash flow, customer growth rate and revenues were materially misstated for reasons set forth in ¶ 140 (a)-(e). *supra*.

130. On February 16, 2000, Charter announced its fourth quarter 1999 financial results:

> **Charter Communications, Inc. Announces Fourth Quarter Financial Results for 1999**
>
> ST. LOUIS—(BUSINESS WIRE)—Feb. 16, 2000—Charter Communications, Inc. (Nasdaq: CHTR) announced today financial results for the three months and the year ended December 31, 1999.
>
> "Charter Communications ended 1999 with strong fourth quarter operating results and the company

is in an excellent position to carry that momentum into 2000," said Jerald L. Kent, President and CEO of Charter. "We continued to generate *double-digit cash flow growth and once again will be among the industry leaders in internal customer growth.*" Charter reported that pro forma fourth quarter revenues and adjusted EBITDA were $763.1 million and $370.3 million, respectively, which were in line with expectations. Further, fourth quarter revenues and adjusted EBITDA grew 9.9% and 12.3%, respectively, and internal customer growth was 3.1% over the year-ago period for those cable systems owned or managed by Charter during the comparable periods.

. . . .

Revenues increased by $26.2 million or 9.9% when comparing the revenues for the three months ended December 31, 1999 to the results for the comparable systems for the three months ended December 31, 1998. This increase is due to a net gain of approximately 68,500 or 3.1% basic customers between quarters and retail rate increases implemented in certain of the Company's systems.

. . . .

The Company experienced growth in adjusted EBITDA of approximately $15.5 million or 12.3%

> when comparing adjusted EBITDA for the quarter ended December 31, 1999 to the results for the same systems for the quarter ended December 31, 1999. Adjusted EBITDA margin increased from 47.7% to 48.7% when comparing the similar periods.
>
> [Emphasis Supplied]

131. The February 16, 2000, press release was misleading for the reasons set forth in ¶ 127 (a)-(e), *supra*.

132. On March 28, 2000, Charter filed its Form 10-K for the year-end 1999 with the SEC. The Form 10-K repeated the same financial information that was announced in the press release of February 16, 2000, referenced *supra*, and was signed by defendants Allen, Kent and Kalkwarf. In its "Report of Independent Public Accountants," defendant Arthur Andersen gave the following unqualified opinion on Charter's financial statements contained in its 1999 Form 10-K:

> In our opinion, based on our audits and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Charter Communications, Inc. and subsidiaries as of December 31, 1999 and 1998, and the results of their operations and their cash flows for the year ended December 31, 1999 and for the period from December 24, 1998, through December 31, 1998, in conformity with accounting principles generally accepted in the United States.

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133. This statement is false and misleading for reasons set forth in ¶ 127(a)-(e), *supra*.

134. On May 3, 2000, Charter announced first quarter 2000 results in a publicly disseminated press release:

> **Charter Communications, Inc. Announces First Quarter 2000 Financial Results**
>
> ST. LOUIS—(BUSINESS WIRE)—May 3, 2000—Charter Communications, Inc. (Nasdaq:CHTR) today announced financial results for the three months ended March 31, 2000. Pro forma for the acquisition of Bresnan Communications in February 2000, revenues were $759.3 million and operating cash flow after deducting corporate overhead was $352.0 million for the first quarter of 2000 . . .
>
> . . . .
>
> Revenues increased by $27.2 million or 10.2% when comparing the revenues for the three months ended March 31, 2000 to the results for the comparable systems for the three months ended March 31, 1999. This increase is due to a net gain of approximately 51,900 or 2.4% basic customers between quarters and retail rate increases implemented in certain of the Company's systems.
>
> . . . .

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> The Company experienced growth in operating cash flow of approximately $17.4 million or 13.7% when comparing operating cash flow for the quarter ended March 31, 2000 to the results for the same systems for the quarter ended March 31, 1999. Operating cash flow margin increased from 47.2% to 48.7% when comparing the similar periods.

135. The foregoing 1Q00 results were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

136. On May 12, 2000, Charter filed its Form 10-Q for the first quarter of 2000 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of May 3, 2000, referenced *supra*, and stated (as did each subsequent Form 10-Q issued during the Class Period) that the accompanying consolidated financial statements "have been prepared in accordance with generally accepted accounting principles . . . for interim financial information and the rules and regulations of the Securities and Exchange Commission," and "include all adjustments, which consist of only normal recurring adjustments, necessary for a fair presentation of the results for the periods presented." The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

137. On August 2, 2000, Defendants continued to mislead investors, when announcing Charter's second quarter 2000 results in a press release:

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Charter Communications, Inc. Announces Second Quarter 2000 Financial Results; Increases in Revenue, Operating Cash Flow, and Customers Continue

ST. LOUIS—(BUSINESS WIRE)—Aug. 2, 2000—Charter Communications, Inc. (Nasdaq: CHTR) today reported increases in revenue, operating cash flow, and customers for the three months ended June 30, 2000.

Revenue grew 9.8% to $794.8 million and operating cash flow increased 16.4% to $373.2 million for the second quarter of 2000 compared to the pro forma results for the second quarter of 1999. For those cable systems owned or managed by Charter during the second quarter of both 2000 and 1999, revenue and operating cash flow grew 12.8% and 15.6%, respectively, and customer growth was 2.3% over the year-ago period.

138. The foregoing 2Q00 results were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

139. On August 14, 2000, Charter filed its Form 10-Q for the second quarter of 2000 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of August 2, 2000, referenced *supra*. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

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140. On November 2, 2000, Charter disseminated a press release announcing the Company's third quarter 2000 financial results. Again, the Company touted the growth in Charter's basic cable customer numbers:

> **Charter Communications Reports Continued Revenue, OCF, and Customer Growth in Third Quarter 2000 Financial Results**
>
> Aggressive Digital Video Deployment Contributes to 20% OCF Growth
>
> ST. LOUIS—(BUSINESS WIRE)—Nov. 2, 2000—Charter Communications, Inc. (Nasdaq: CHTR) today reported continued growth in revenues, operating cash flow (OCF), and basic, digital and data customers for the three months ended September 30, 2000, compared to pro forma year-ago results.
>
> Third Quarter Highlights
>
> Pro forma revenues increased 13.9% to $842.9 million and pro forma operating cash flow increased 20.2% to $400.6 million for the third quarter of 2000 compared to the pro forma results for the third quarter of 1999. Charter added over 55,000 basic cable customers during the third quarter, contributing to a year-to-year increase of approximately 2.3% compared to the pro forma customer level of 6,178,800 at September 30, 1999. . . .

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For "same-store" cable systems owned by Charter during the third quarter of both 2000 and 1999, revenues and system operating cash flow grew 12.8% and 19.5%, respectively. These systems represented 2,671,000 customers at September 30, 2000, reflecting a 2.3% growth rate in basic customers compared to a year ago.

141. The foregoing 3Q00 results were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

142. On November 13, 2000, Charter filed its Form 10-Q for the third quarter of 2000 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of November 2, 2000, referenced *supra*. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

143. On February 15, 2001, Charter continued to mislead investors when announcing its 2000 year-end results in the following press release:

Charter Communications Reports Continued Revenue, OCF, and Customer Growth in Fourth Quarter 2000 Financial Results

Aggressive Digital and High-Speed Data Deployment to Drive 2001 Growth

ST. LOUIS—(BUSINESS WIRE)—Feb. 15, 2001—Charter Communications, Inc. (Nasdaq:

CHTR) today reported continued acceleration in the growth of revenues, operating cash flow (OCF), and basic, digital and data customers for the three months ended December 31, 2000, compared to pro forma year-ago results and compared to all other quarters in 2000.

2000 Financial Highlights

Jerry Kent, President and CEO, said "I'm pleased to report that we met, or in most cases significantly exceeded, all of the goals we set at the start of the year, *as well as those expected by Wall Street analysts*. In the fourth quarter, we capped the year with OCF growth that is *almost twice that of any other major cable operator*. We saw *acceleration in core basic customer growth*, which indicates the success of our digital strategy. And we ended the year with advanced service deployments that exceeded our original optimistic expectations. . . ."

For the fourth quarter of 2000, revenues increased 15.8% to $893.9 million, and OCF increased 28.9% to $433.2 million compared to the pro forma results for the fourth quarter of 1999. Pro forma revenues and OCF for the year 2000 increased 11.9% to $3.30 billion and 19.0% to $1.56 billion, respectively, compared to pro forma 1999 annual results. Pro forma internal customer growth was 2.5% for the year 2000. "*We apparently retained our industry leadership in*

> *generating internal customer growth," Mr. Kent said. "Our aggressive approach to competition has enabled us to accelerate our internal customer growth throughout the year,"* he continued. At December 31, 2000, Charter served 6,350,900 basic cable customers, compared to 6,193,700 pro forma as of December 31, 1999, a pro forma net gain of 157,200 customers.
>
> For "same-store" cable systems owned by Charter during the fourth quarter of both the years 2000 and 1999, revenues and system operating cash flow grew 18.3% and 28.9%, respectively. These systems represented 3,783,600 customers at December 31, 2000, reflecting a 2.2% internal growth rate in basic customers compared to a year ago.
>
> [Emphasis Supplied].

144. The foregoing 4Q00 and year end 2000 results were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*. In addition, the foregoing results were materially inflated as a result of Charter's sham transactions with Scientific-Atlanta and Motorola by which Charter agreed to pay additional monies for goods, in return for these vendors paying Charter advertising fees.

145. On February 28, 2001, Charter filed its Form 10-K for the year-end 2000 with the SEC. The Form 10-K repeated the same financial information that was announced in the press release of February 15, 2001, referenced *supra*,

and was signed by defendants Allen, Kent and Kalkwarf. Charter's Form 10-K for the year ended 2000 was materially false and misleading. In its "Report of Independent Public Accountants," defendant Arthur Andersen gave the following unqualified opinion on Charter's financial statements contained in its 2000 Form 10-K:

> In our opinion, based on our audits and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Charter Communications, Inc. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations and their cash flows for the years then ended, and for, the period from December 24, 1998, through December 31, 1998, in conformity with accounting principles generally accepted in the United States.

146. On May 2, 2001, Charter announced its first quarter 2001 results in the following press release:

> **Charter Communications Announces Solid First Quarter Results; Digital Video and High-Speed Data Deployments Exceed Expectations**
>
> ST. LOUIS—(BUSINESS WIRE)—May 2, 2001—Charter Communications, Inc. (Nasdaq: CHTR) today reported revenue and operating cash flow growth at the high end of previously stated guidance for the first quarter of 2001 . . .

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First Quarter Financial Highlights

For the first quarter of 2001 revenues increased 14.4% to $873.8 million, and operating cash flow (OCF) increased 9.7% to $387.9 million compared to the pro forma results for the first quarter of 2000. Charter increased its customer base by over 2.0% compared to pro forma first quarter of 2000 to 6,349,800 customers. "We continue to deliver by increasing revenue and OCF through internal and advanced broadband services customer growth made possible by our digital platform," Mr. Kent said.

147. In a conference call with analysts following the release of its quarterly results, senior Charter officers expressed confidence that its annual basic customer growth would exceed 2%, indicating an acceleration throughout the balance of the year. The Company attributed this increase in growth, in part, to "decreasing churn," i.e. decreasing loss of existing customers. (See UBS Warburg; ABN AMRO, 5/3/01).

148. The foregoing 1Q01 results and statements in the conference call were materially false, misleading and without reasonable basis for the reasons set forth in ¶ 127(a)-(e), *supra*.

149. On May 15, 2001, Charter filed its Form 10-Q for the first quarter of 2001 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of May 2, 2001, referenced *supra*. The

Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

150. Indicative of the degree to which analysts were beguiled by Charter's fraudulent image, Credit Suisse First Boston resumed coverage of the Company on June 4, 2001 with a "Strong Buy" recommendation based on Charter's perceived subscriber growth rate that was "twice industry average," attributable to "falling churn, better customer service and more sophisticated settling techniques." On June 5, 2001, Deutsche Bank issued a report projecting pro forma EBITDA growth at 14-16% for the year. Recommendations such as these, which were based on defendants' fraudulent representations and guidance to analysts, propelled Charter's stock price to over $22 per share.

151. On July 30, 2001, Charter continued to mislead investors when the Company announced its second quarter 2001 results in the following press release, which states in part:

> **Charter Communications Exceeds Revenue, Operating Cash Flow Guidance; Strong Digital Video, High-Speed Data and Basic Customer Increases Continued During Second Quarter**
>
> ST. LOUIS—(BUSINESS WIRE)—July 30, 2001—Charter Communications, Inc. (Nasdaq: CHTR) today reported second quarter 2001 revenue and operating cash flow growth exceeding Wall Street estimates. Increases in digital video,

high-speed data, and basic video customers during the three-month period ended June 30, 2001 were in line with the company's previously stated guidance, according to Jerry Kent, President and CEO.

Second Quarter Financial Highlights

For the second quarter of 2001, revenue increased 16.1% to $928.5 million, and operating cash flow increased 14.1% to $428.1 million compared to pro forma results for the second quarter of 2000. This compares favorably to previous guidance of 13%-15% revenue growth and 11.5%-13.5% operating cash flow growth for the second quarter. Charter reported internal customer growth of 2.1% compared to pro forma second quarter of 2000 for a total of 6,388,300 customers. . . .

152. A conference call after the release of these results reinforced the upbeat, albeit false, impression provided analysts. As Richard Bilotti from Morgan Stanley Dean Witter commented in a report issued at the time, "The most important takeaway from the quarter and the call with management is the company's strong belief in the sustainability of these growth rates."

153. The foregoing 2Q01 results and statements to analyst were materially false, misleading and without reasonable basis for the reasons set forth in ¶ 127(a)-(e), *supra*.

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154. On August 13, 2001, Charter filed its Form 10-Q for the second quarter of 2001 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of July 30, 2001. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

155. On September 11, 2001, Charter announced preliminary third quarter 2001 results:

> **Charter Communications Expects Accelerated Growth in Third Quarter 2001 Advanced Services; Company Will Shift Focus From Basic Customer Growth to Advanced Services**
>
> PASADENA, Calif.—(BUSINESS WIRE)—Sept. 11, 2001—Charter Communications, Inc. (Nasdaq:CHTR) said today that based on third quarter digital and high-speed data sales to date, it expects third quarter 2001 advanced services additions to exceed those of second quarter 2001. Charter President and CEO Jerry Kent said the Company expects to meet or exceed the high end of guidance for year-end digital and high-speed data customers.
>
> . . . . Mr. Kent said Charter has made a strategic decision to focus more of its marketing expenditures and management time on advanced service growth. "We've reviewed our internal marketing plans, management focus and current

operating results in light of the current economic environment, and believe that a rebalancing of emphasis to digital and data sales at the expense of marginal increases in basic customer growth is the right business decision. Our number one priority now is to increase digital and data customers which provide higher profitability and competitive advantage."

Mr. Kent said he expects Charter's basic customer growth for 2001 to be less than the original guidance of at least 2 percent as a result of this refocus. "We'll remain mindful of the ongoing need for internal basic customer growth, and I'm confident Charter will continue to lead the industry as we have for the past five years."

"As advanced services are deployed to a rapidly growing number of customers, operating cash flow growth accelerates," Mr. Kent said. "Pro forma operating cash flow growth for the first half of 2001 was 11.1 percent. Despite the slowdown in economic conditions, this growth rate is expected to accelerate for the remainder of the year."

[Emphasis Supplied.]

156. The foregoing statements were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

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157. While the foregoing representations were false and misleading, they were the first signal of a decline in Charter's customer growth rate. Indicative of the stock price inflation that had resulted from Charter's reports and projections of customer growth rates which had been bloated by the "hold disconnects" practice and other devices described above, this first disclosure triggered a 20% decline in the price of the Company's stock price, from a close of $20.04 on September 7, 2001, to a close of $16.00 on September 21, 2001, at 2-3 times the normal trading volume.

158. Further indicative of the emphasis that defendant Allen had placed on customer growth rate, following this reported decline in rate, defendant Kent was ousted as the Company's President and CEO. This was announced on September 24, 2001. News reports attributed Kent's departure to undisclosed disagreements and personality conflicts with defendant Allen.

159. This news further unsettled investors, who further bailed out of the Company, resulting in a decline in the price of Charter's stock to $12.00 per share on September 27, 2001. Consistent with the concerns raised by these events, Goldman Sachs reduced its EBITDA estimates for 2001, citing the "slower sub growth rate." (10/9/01)

160. On October 9, 2001, Charter named defendant Vogel as the Company's new President and CEO.

161. On November 1, 2001, defendants announced Charter's final third quarter 2001 results in a press release, which stated in part:

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Charter Communications Reports Strong Third Quarter Advanced Services Growth

Company Continues to Pace the Industry with Internal Customer Growth

ST. LOUIS B Charter Communications, Inc. (Nasdaq: CHTR) today reported double digit revenue and operating cash flow growth for the third quarter of 2001 resulting from continued consumer demand for broadband services. These results were highlighted by the addition of a record number of new cable modem customers during the third quarter.

. . . .

Third Quarter Financial Highlights

For the third quarter of 2001, revenue increased more than 13% to $1.04 billion, and operating cash flow increased more than 10% to $467.5 million compared to pro forma results for the third quarter of 2000. Charter continued to pace the industry with internal customer growth of 1.1% compared to pro forma third quarter of 2000 for a total of 6,970,100 customers. "Basic customer growth has slowed after a planned reduction in discounting and basic service marketing efforts, part of a previously announced strategic shift of focus to advanced services that will better enhance operating cash flow growth. This focus is starting

> to pay off, as evidenced by our impressive advanced services growth. I'm especially proud of the men and women of Charter for their perseverance in these challenging times," Mr. Vogel said.

162. The foregoing 3Q01 results were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

163. On November 14, 2001, Charter filed its Form 10-Q for the third quarter of 2001 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of November 1, 2001, referenced *supra*. The Form 10-Q was signed by defendant Kalkwarf. It was materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

164. Investors became increasingly skeptical about Charter following the departure of defendant Kent, and particularly as concerns surfaced about the nature of its previously reported significant customer growth rates. In late 2001, the market began learning that Charter had engaged in a "practice of aggressively driving basic subscriber growth over the last two years" which had purportedly enabled the Company to increase its subscriber "base roughly twice as fast as its peers in 1999, 2000, and through much of 2001" (See October 4, 2002 Bank of America Securities report). As the Company began acknowledging that its growth rates were slowing, even some analysts became more cautious about the Company (still unaware that the prior growth rate was not simply the result of aggressiveness, but of covert manipulation of the figures).

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165. Thus, on January 10, 2002, Morgan Stanley analyst Richard Bilotti reduced his rating from "Strong Buy" to "Outperform," citing slowing EBITDA growth, which, now at 10%, was "about 100-200 basis points below the industry average." This came on the heels of the Company's acknowledgment on November 1, 2001, that its subscriber growth rate, which had been at 2.3% a year prior, had declined to 1.1% in the most recent quarter. These concerns caused the market price of Charter stock, which had been over $16 per share at the beginning of 2002, to plummet over 20% to $13 per share by January 18, 2002. (These growth rates, while reduced, were still artificially buoyed by Charter's "hold disconnects" practices detailed in ¶¶ 59 to 74, *supra*.)

166. On February 11, 2002, Charter continued to mislead investors when it announced its 2001 year-end results in a press release, which stated in part:

> **Charter 2001 Pro Forma Cable Modem and Digital Customers Increase Nearly 165% and 82%, Respectively**
>
> ST. LOUIS — Charter Communications, Inc. (Nasdaq: CHTR) today reported revenue growth that exceeded its guidance, and cash flow growth at the top of its estimated range for the year 2001. These results were highlighted by the addition of a near record number of new cable modem customers during the fourth quarter.
>
> . . . .

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As of December 31, 2001, Charter Digital Cable™ customers totaled 2,144,800 with fourth quarter weekly additions averaging approximately 15,000 installations per week. "Charter continues to experience strong demand for its digital video service, resulting in industry leading penetration. As we continue to add interactive products like video on demand (VOD), and personal interactive channels, we see enhanced customer satisfaction, reduced digital churn, and improved retention levels," Mr. Vogel said.

. . . .

Fourth Quarter Financial Highlights

Revenue during the fourth quarter of 2001 increased 13.6% to $1.1 billion, and operating cash flow increased 11.0% to $502.6 million compared to pro forma results for the fourth quarter of 2000, before a special charge including the @Home conversion of $17.6 million. Year-end 2001 pro forma revenue was over $4.1 billion, up 14.0% from pro forma 2000 revenue of $3.6 billion. Pro forma operating cash flow increased 10.9% from $1.65 billion to $1.83 billion for 2001, before a special charge including the @Home conversion of $17.6 million.

167. In connection with the announcement of these year-end results, Charter hinted for the first time that its customer base had been materially inflated. However, it did so in a

misleading manner so as to avoid any critical examination of its prior representations. The Company stated that it expected to remove approximately 120,000 "marginal customers" from its basic customer account in the first quarter of 2002, and that it had increased its reserves for uncollected accounts receivable as of December 31, 2001. This write-off represented two years of the company's basic customer subscriber growth.

168. The foregoing 4Q01 results were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*. In addition:

a. The reasons given for the write-off of customers was false and misleading. The Company sought to give the impression that it was taking an initiative to make its customer base even stronger by eliminating those that may have paid their bills, but were "marginal" and thus not profitable. Indeed, as an analyst at Banc of America Securities characterized it, Charter had merely decided to "disconnect unprofitable subscribers." (April 29, 2002 report.)

b. In fact, the Company was now doing what it should have done long before, i.e., write-off customers who had themselves sought to terminate their accounts. The statement was designed and intended to deflect attention from the fact that Charter's internal customer growth rate had been materially smaller than represented. In fact, the write-off of these customers was needed because the Company had been holding disconnects of well over 100,000 customers cumulatively during the Class Period.

c. Moreover, the Company failed to disclose the full extent of its potential write-off. At the same time Charter wrote-off 120,000 customers, it created a "reserve" for disconnecting 45,000 additional customers.

169. On March 29, 2002, Charter filed its Form 10-K for the year-end 2001 with the SEC. The Form 10-K repeated the same financial information that was announced in the press release of February 11, 2002, referenced *supra*, and was signed by defendants Allen, Vogel and Kalkwarf. The Company raised the number of customers written off to 145,000 (from the previously announced 120,000). It was materially false and misleading for the reasons set forth in ¶ 127(a)-(c), *supra*.

170. In its "Report of Independent Public Accountants," defendant Arthur Andersen gave the following unqualified opinion on Charter's financial statements contained in its 2001 For 10-K:

> In our opinion, based on our audits and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Charter Communications, Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

171. This was false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

172. Defendants continued to mislead investors in a press release dated April 29, 2002;

> **Charter Posts Strong Revenue and Cash Flow Growth For the First Quarter of 2002**
>
> Strategic marketing and bundling of services drives first quarter 2002 revenue and operating cash flow growth
>
> ST. LOUIS — Charter Communications, Inc. (Nasdaq: CHTR) exceeded expectations for revenue and cash flow growth during the first quarter of 2002.
>
> First Quarter Financial Highlights
>
> Revenue during the first quarter of 2002 increased 13.1% to $1.1 billion, and operating cash flow increased 10.4% to $449.2 million compared to pro forma results for the first quarter of 2001. "Our revenue and cash flow for the quarter exceeded the high end of our expectations and will provide a solid base of growth which we expect to accelerate throughout the year," Mr. Vogel said. Charter reported basic and diluted loss per share of $.59 for the first quarter of 2002, compared to a loss per share of $1.20 for the first quarter of 2001.

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173. The foregoing 1Q02 results were materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

174. By this time though, even upbeat analysts were beginning to acknowledge that the decline in the Company's stock price (to a closing price of $7.79 per share on May 13, 2002), was attributable to growing investor skepticism triggered by the February write-off of customers. As a Credit Suisse analyst commented in a report dated May 14, 2002:

> The Company recently announced it would have to write down 120,000 basic video subscribers due to nonpayment, which represent 2 years of subscriber growth and a significant credibility issue with investors.

175. On May 14, 2002, Charter filed its Form 10-Q for the first quarter of 2002 with the SEC. The Form 10-Q repeated the same financial information that was announced in the press release of April 29, 2002, referenced *supra*. The Form 10-Q was signed by defendants Kalkwarf and Martin. It was materially false and misleading for the reasons set forth in ¶ 127(a)-(e), *supra*.

176. The market price of Charter stock continued to descend as investors, aware of the unraveling fraud at Adelphia, were concerned that the same thing might have occurred at Charter as well. By June 13, 2002, Charter's stock price had sunk to $4.48 per share. At this point, one of the Company's boosters, Morgan Stanley, came to the Company's defense in an analyst report dated June 14, 2002, seeking to assure investors that Charter was not another Adelphia. The

report was written after further communication with Charter management, including defendants Barford and Kalkwarf:

> We believe that Charter does not represent a risk for accounting inconsistencies or revisions to prior financial performance. Since its public offering in late 1999, Charter has remained consistent with respect to how it recognizes revenue, capitalizes labor, and depreciates its network. We believe that the panic selling that has occurred over the last few months as the Adelphia situation has unraveled, represents a buying opportunity. . . .
>
> We estimate that Charter capitalizes about $325-350 million of installation and engineering labor costs each year. These estimates are within the range for the group, but not at the lower end of the range for the industry . . . *It is very important to recognize that Charter has consistently applied its capitalization policies and has not made accounting changes that might have distorted revenue and EBITDA growth rates.*
>
> [Emphasis Supplied].

177. The foregoing statements by Morgan Stanley, which helped boost the price of Charter stock by over 20% in one day, were indicative of the degree to which defendants had misled investors, since, contrary to the analyst's conclusions, Charter had indeed consistently capitalized labor charges that it knew, even under its own policies, should have been expensed.

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Revelations

178. On July 18, 2002, one day after the end of the Class Period, Merrill Lynch published a Comment concerning Charter by analyst Jessica Reif Cohen ("Cohen") entitled "Q2E: Basic Sub Losses Continue and Accounting Worries Not Over; Downgrade to Neutral;"

> We are reducing our intermediate term investment rating to Neutral from Strong Buy due to Charter's high leverage, lack of positive free cash flow generating for at least 18 months and continued accounting worries in general for the sector. Additionally, investors remain averse to highly leveraged companies with no earnings and no free cash flow, i.e. companies with EBITDA-based valuations.
>
> . . . .
>
> Accounting Practices
>
> We believe that Charter's upcoming June 10Q filing will include more detail about its accounting practices, including subscriber count calculations and marketing deals with equipment vendors. Further, Charter plans to offer more clarity in its capital expenditures and debt covenants. While we applaud Charter's decision, the release of more detail could be a double-edged sword. While investors are likely to appreciate the more detailed filing, since they have been clamoring for more

transparency, investors might not be reassured by what they uncover.

While accounting practices are relatively similar across the industry, there are some differences across cable operators. We believe that Charter has a more aggressive capitalization policy, evidenced by its top-of-the-industry EBITDA margins and also its high capex spending per basic subscriber (although some of that is partially due to Charter's lower densities). Further Charter includes some of its programming launch fees in cable advertising revenue (similar to AOL but unlike Cox, Comcast and Cablevision). This is actually significant and consisted of roughly one third ($100 million) of total CY01 advertising revenue at essentially 100% EBITDA margins. In addition, we understand that Charter allocates the $10/month incremental revenue from its data-only subscribers (data-only subs. are typically charged an additional $10 for not taking a bundle of data+video) to basic cable revenue and hence includes the subscriber in the basic cable subscriber count. While we believe this is a very insignificant number, the mere fact that Charter is taking such an aggressive stance could lead investors to question all its practices. Moreover, we understand that Charter has done some marketing deals with equipment vendors (as does Comcast).

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179. The partial disclosure of Charter's improper accounting practices, as described in Cohen's July 18, 2002 Comment, had an immediate and sharply negative effect on Charter's stock price. On that day, Charter's stock dropped more than thirteen percent (13%), falling from the previous day's close of $4.06 per share, to close of $3.50 per share on July 19, 2002.

180. Indeed, Charter's use of misleading accounting practices to artificially inflate its revenue and earnings was further detailed in the August 12, 2002, issue of *Forbes*, which quoted a July 12, 2002, report by Credit Suisse First Boston concerning the cable industry. The *Forbes* article stated in pertinent part:

> The [Credit Suisse] report provides a detailed look at "churn," which is essentially cable's costs for labor and advertising. Credit Suisse says that cable companies have been hiding the impact of their churn by capitalizing labor costs. In other words, if they spend $50 to install cable in a home, the cable guys only subtract $20 from revenues to calculate the current period's earnings. Then they spread the rest over a dozen years. The worst offender, Credit Suisse says, is Charter Communications, which capitalizes $29 per customer.

181. On August 16, 2002, Charter acknowledged that it had received a subpoena for documents from a federal grand jury that was conducting a criminal investigation of "the Company's current and disconnected customers, and its

policies and procedures related to the capitalization or expense of various costs and related matters." The Company further admitted that the investigation probably related in part to the matters raised by the CSFB and Merrill Lynch analyst reports. The investigation also followed on the heels of the Company's announcement that it was increasing its reserves to account for its decision to disconnect 145,000 "marginal" customers. **Charter's stock fell a statistically significant amount following this disclosure.**

182. On October 22, 2002, Charter announced that it was placing its COO, defendant Barford, on paid leave, pending the previously announced Grand Jury investigation.

183. On December 3, 2002, the Company announced that defendant William Shreffler, who was then Senior Vice President of Operations for the Midwest Division, resigned his position, "citing personal reasons."

184. On December 23, 2002, Charter announced that it was firing defendants Barford and Kalkwarf, and reauditing its books for 2000 and 2001. "The terminations of Messrs. Barford and Kalkwarf follow a review by the Company of various matters, including those related to the Grand Jury investigation," a Company spokesman said.

185. As a result of these revelations, Charter's shares dropped to a 52-week low of $0.78 on October 11, 2002, down approximately 97% from its Class Period high of $26.31.

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186. On April 1, 2003, Charter announced the "preliminary results" of the reaudit for years 2000 and 2001. As a result of the reaudit, the following major restatements were made:

	2001 ($ millions)	*2000* ($ millions)
Revenue Reduced by:	$146	$108
Expenses Increased by:	*$146*	*$ 87*
EBITDA Reduced by:	$292	$195

187. The Company acknowledged that as a result of the foregoing, its pro forma adjusted EBITDA for 2001, which had previously been reported as $1.8 billion, was restated to only $1.543 billion. Similarly, whereas reported pro forma adjusted EBITDA for 2000 had been previously reported as $1.6 billion, it was restated to only $1.454 billion. Thus, in contrast to the previously reported EBITDA growth rate between 2001 and 2000 of 12.5%, the actual growth rate was only 6%.

188. There were further materially adverse adjustments announced for the first 3 quarters of 2002, though there was no indication of the portion of those adjustments that related only to the first quarter of 2002.

189. The April 1, 2003 press release also stated:

(a) Launch Incentives From Programmers.

Amounts previously recognized as advertising revenue in connection with the launch of new

programming channels have been deferred in the year such launch support was provided, and amortized as a reduction of programming costs based upon the relevant contract term. Such adjustments decreased revenue $30 million for the first three quarters of 2002, and $118 million and $76 million for the years ending December 31, 2001 and 2000, respectively. Additionally, for the year ending December 31, 2000, the company increased marketing expense by $24 million for other promotional activities associated with launching new programming services previously deferred and subsequently amortized. The corresponding amortization of such deferred revenues reduced programming expenses by $36 million for the first three quarters of 2002, and $27 million and $5 million for the years ending December 31, 2001 and 2000, respectively.

(b) Capitalized Labor and Overhead Costs.

Certain elements of labor costs and related overhead allocations previously capitalized as part of the Company's rebuild activities, customer installation and new service introductions have been expensed in the period incurred. Such adjustments increased operating expenses by $73 million for the first three quarters of 2002, and $93 million and $52 million for the years ending December 31, 2001 and 2000, respectively.

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(c) Customer Acquisition Costs.

Certain customer acquisition campaigns were conducted through third party contractors in 2000, 2001 and portions of 2002. The costs of these campaigns were originally deferred and recognized as amortization expense over the relevant customer contract terms. These amounts have been reported as marketing expense in the period incurred and totaled $32 million for the first three quarters of 2002, and $59 million and $4 million and for the years ending December 31, 2001 and 2000, respectively. The company determined in the second quarter of 2002 that the benefits of this program did not justify its continued practice and it was eliminated in the end of the third quarter as contracts for third party vendors expired.

190. In response to these disclosures, Deutsche Bank Securities, Inc., issued analyst reports noting that Charter's "adjustments" of $487 million to previously reported EBITDA represented "*significant* reductions relative to the restated pro forma totals. . . ." [Emphasis Supplied]. A. G. Edwards issued a similar report stating "we believe that the breadth of these restatements are significant. . . ."

191. The Company also disclosed for the first time that there had been "45,000 accounts that were reserved at year end 2001 to address pending disconnects." This was in addition to the 120,000 customers the Company had announced it would be writing off at the time. (In fact, the

Company wrote-off an additional 25,000 customers by July 2002, and had no "reserve" for customer disconnects at year end 2002.)

192. With respect to the ongoing Grand Jury investigation, Charter stated:

> The adequacy of the 45,000 customer reserve, the disconnect policies, the application of those policies and their effect on the customer totals reported by the Company during 2001 and prior periods are currently under investigation by the United States Attorney's Office for the Eastern District of Missouri and the Securities and Exchange Commission.

193. Finally, the Company acknowledged that these restated results were "preliminary" and that it had filed for an extension "to provide additional time to finalize its financial statements, related filings, disclosures and audits."

The Indictment and Guilty Plea

194. On July 24, 2003, the Grand Jury returned an Indictment charging that:

> Beginning in or about May 2001 and continuing through in or about March 2002, Barford, Kalkwarf, McCall and Smith knowingly devised and intended to devise a scheme to defraud investors in Charter securities and the investing public . . . by falsely inflating Charter's subscriber

numbers and subscriber growth numbers and by making false statements relating to Charter's subscriber numbers and subscriber growth numbers, in order to inflate artificially Charter's stock price. . . . (Indictment ¶ 44).

195. The Indictment further charged that:

Beginning in or about August 2000, and continuing through on or about February 11, 2001, Kalkwarf and Barford knowingly devised and intended to devise a scheme to defraud investors in Charter securities . . . by falsely inflating Charter's publicly reported year end revenue and operating cash flow and by making false statements relating to the inflated revenue and operating cash flow, in order to inflate artificially Charters' stock price. . . . (Indictment ¶ 17).

196. In his guilty plea entered the next day, on July 25, 2003, defendant McCall admitted that:

From in or about June of 2001 and continuing until in or about March of 2002 . . . David McCall did knowingly and willfully participate in a scheme to defraud Charter's stockholders by means of materially false and fraudulent pretenses, presentations and promises. (Guilty Plea at 9)

197. That same day, at a hearing before the Honorable Carol Jackson, defendant McCall stated:

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> I was instructed to meet certain quarterly expectations, in terms of company expectations for how many customers you gained on a quarterly basis. Did that. And instructed people that worked for me to do that and knowing that, you know, that those numbers would in turn be used to meet forecasts that would be done in a public – to the public environment like Wall Street. (Transcript at 16-17)

COUNT I

VIOLATIONS OF §§ 11, 12 AND 15 OF THE SECURITIES ACT AGAINST ALL CHARTER RELATED DEFENDANTS OTHER THAN VOGEL

198. Lead Plaintiff repeats and re-alleges, as if fully set forth herein, those paragraphs regarding the initial public offering of Charter stock; the false and misleading statements made in connection therewith; and the reasons why those statements were false and misleading, *i.e.*, **¶¶ 127, *supra***. This claim does not sound in fraud, and neither fraud nor scienter is an element of this claim. None of the paragraphs regarding defendants' scienter are incorporated herein.

199. This claim is brought by Lead Plaintiff on behalf of all persons who purchased shares of Charter stock pursuant to the IPO Registration Statement. Lead Plaintiff and other Class members acquired their shares pursuant to or traceable to the Registration Statement.

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200. Defendants (other than Vogel, Scientific-Atlanta and Arthur Andersen) issued and disseminated, caused to be issued and disseminated, and participated in the issuance and dissemination of, materially false and misleading written statements to the investing public which were contained in the Registration Statement, which misrepresented or failed to disclose, *inter alia*, the facts set forth above in ¶ 127(a)-(e), *supra*. Charter issued the Prospectus and Registration Statement that accompanied the IPO. Each of the Individual Defendants (other than Vogel) was an officer, director, or controlling person of Charter at the time of the IPO.

201. As a direct and proximate result of defendants' acts and omissions in violation of the Securities Act, the market price of Charter stock was artificially inflated in the IPO, and Lead Plaintiff and the Class suffered substantial damage in connection with their purchase of Charter common stock pursuant to the Registration Statement and Prospectus.

202. At the times they purchased their shares in the IPO, Lead Plaintiff and members of the Class who purchased such shares were without knowledge of the facts concerning the false or misleading statements or omissions alleged herein.

203. Less than two years elapsed from the time that the events upon which this action is based, to the time that this action was filed. Less than five years elapsed from the time that the securities upon which this claim is brought were offered to the public to the time this action was commenced.

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COUNT II

VIOLATIONS OF § 10(B) OF THE EXCHANGE ACT AND RULE 10B-5 PROMULGATED THEREUNDER AGAINST ALL CHARTER RELATED DEFENDANTS

204. Lead Plaintiff repeats and realleges each and every allegation contained in the paragraphs above as if fully set forth herein.

205. At all relevant times, the Charter Related Defendants, individually and in concert, directly and indirectly, by the use and means of instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct whereby they knowingly and/or with deliberate recklessness made and/or failed to correct public representations which were or had become materially false and misleading regarding Charter's financial results and operations as set forth in **¶¶ 96 - 136**, *supra*. These statements were materially false and misleading for reasons stated in ¶ 127(a)-(e), *supra*.

206. Defendant Charter was a direct participant in the wrongs complained of herein. The Individual Defendants are liable for the wrongs complained of herein as direct participants in and controlling persons of the Company. By virtue of their positions of control and authority as officers, directors and controlling shareholder of Charter, the Individual Defendants were able to and did, directly or indirectly, control the preparation, issuance and/or content of the aforesaid public statements relating to the Company. Portrait photographs of each of the Individual Defendants

were included in Charter's 2000 or 2001 Annual Reports. Each of the Individual Defendants participated in making the false and misleading statements under the group publication doctrine.

207. The Charter Related Defendants had actual knowledge of the facts making the material, statements false and misleading, or deliberately acted with reckless disregard for the truth in that they failed to ascertain and to disclose such facts, even though same were available to them as set forth in ¶¶ 128-139, *supra*. In addition:

1. As officers, directors and/or controlling persons of a publicly held company whose common stock is registered with the SEC under the Exchange Act and traded on the Nasdaq, the Individual Defendants had a duty to promptly disseminate accurate and truthful information with respect to the Company's operations, finances, financial conditions, and present and future business prospects, to correct any previously issued statement from any source that had become untrue, and to disclose any trends that would materially affect earnings and the present and future operating results of Charter, so that the market price of the Company's publicly traded securities would be based upon truthful and accurate information.

2. During the Class Period, the Individual Defendants were senior executives and directors of Charter and were privy to confidential and proprietary information concerning Charter, its operations, finances, financial condition, products, and present and future business prospects via internal corporate documents, conversations

and connections with other corporate officers and employees, attendance at management and Board of Directors meetings and committees thereof, and via reports and other information provided to them in connection therewith.

208. In ignorance of the adverse facts concerning Charter's business operations and earnings, and in reliance on the integrity of the market, Lead Plaintiff and the members of the Class acquired Charter common stock at artificially inflated prices and were damaged thereby.

209. Had Lead Plaintiff and the members of the Class known of the materially adverse information not disclosed by the Charter Related Defendants, they would not have purchased Charter common stock at all, or not at the inflated prices paid.

210. By virtue of the foregoing, the Charter Related Defendants have violated Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.

COUNT III

VIOLATION OF § 20(a) OF THE EXCHANGE ACT AGAINST THE INDIVIDUAL DEFENDANTS

211. Lead Plaintiff repeats and realleges each and every allegation contained in the paragraphs above as if fully set forth herein.

212. This count is asserted against the Individual Defendants and is based upon Section 20(a) of the 1934 Act.

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213. The Individual Defendants, by virtue of their offices, directorships, stock ownership and specific acts were, at the time of the wrongs alleged herein and as set forth in Count II, controlling persons of Charter within the meaning of Section 20(a) of the 1934 Act. The Individual Defendants had the power and influence and exercised the same to cause Charter to engage in the illegal conduct and practices complained of herein by causing the Company to disseminate the false and misleading information referred to above. Moreover, during the Class Period, the defendant Allen controlled a majority of the Company's stock.

214. By virtue of the conduct alleged in Count II, the Individual Defendants are liable for the aforesaid wrongful conduct and are liable to Lead Plaintiff and the Class for damages suffered.

COUNT IV

VIOLATIONS OF § 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 PROMULGATED THEREUNDER AGAINST ARTHUR ANDERSEN

215. Lead Plaintiff incorporates by reference all of the foregoing paragraphs as if realleged herein.

216. Defendant Arthur Andersen served as Charter's independent auditors throughout the Class Period. In that capacity, it performed audits of Charter's books, records, and financial statements for the years 1999, 2000, and 2001. Following such audits, Arthur Andersen issued opinion letters stating that its audits of Charter's financial statements had

been conducted in conformance with Generally Accepted Auditing Standards, and that statements conformed with GAAP.

217. Such statements were false and misleading, for reasons set forth in ¶ 127(a)-(e), *supra*. As set forth in **¶¶ 153 - 157, *supra***, annual reports for 2000 and 2001 have been restated.

218. As Charter's auditor, Arthur Andersen had full access to its books, records and personnel, and knew, or recklessly disregarded, *inter alia*, the facts that:

1. The Company's capitalization rate was the highest in the industry, and resulted from the Company's improper capitalization of costs that clearly should have been expensed;

2. The Company's had a pattern of holding disconnects, which contributed to a significant rise in account receivables that should have been promptly written off; and,

3. The Company improperly accounted for other matters, such as including all launch fees paid by program providers at the initial date of a contact, rather than over the entire term of the contract.

4. Though aware that Charter was seeking to boost its revenues by paying vendors higher prices at the same time it received additional advertising from the same vendors, Andersen failed to properly audit these transaction by confirming them with the vendors.

219. Defendant Arthur Andersen thereby violated §10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

COUNT V

VIOLATIONS OF § 10(b) OF THE EXCHANGE ACT AND RULE 10b-5(a) AND 10B-5(c)) PROMULGATED THEREUNDER AGAINST SCIENTIFIC-ATLANTA AND MOTOROLA

220. Lead Plaintiff incorporates by reference all of the foregoing paragraphs as if realleged herein.

221. As detailed above, defendants Scientific-Atlanta and Motorola engaged in a series of sham transactions whereby it agreed to return to Charter monies paid for additional charges paid for converter boxes and other cable related devices. Such monies were returned in the form of "advertising." Scientific-Atlanta and Motorola agreed to such sham transactions knowing or recklessly disregarding that Charter intended to inflate its reported results by recording the monies it received as revenues, while recording monies it paid to Scientific-Atlanta as capital expenses. Scientific Atlanta and Motorola also knew that analysts would be relying upon such reported amounts in making their recommendations regarding Charter's stock.

222. **These sham transactions constituted a "device, scheme or artifice to defraud" and "an act, practice or course of business which operate[d] . . . as a fraud or deceit" upon Charter investors, in violation of Rule 10b-5(a) and (c)), for which Scientific-Atlanta and Motorola are likewise liable.**

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PRAYER FOR RELIEF

WHEREFORE, Lead Plaintiff demands judgment:

1. Determining that the instant action is a proper class action maintainable under Rule 23 of the Federal Rules of Civil Procedure;

2. Awarding compensatory damages and/or rescission as appropriate against defendants, in favor of Lead Plaintiff and all members of the Class for damages sustained as a result of defendants' wrongdoing;

3. Awarding Lead Plaintiff and members of the Class the costs and disbursements of this suit, including reasonable attorneys', accountants' and experts' fees; and

4. Awarding such other and further relief as the Court may deem just and proper.

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JURY DEMAND

Lead Plaintiff hereby demands a trial by jury.

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5(a) and (c), 17 C.F.R. § 240.10b-5(a) and (c), where Respondents engaged in their own deceptive conduct in transactions with a public corporation for the purpose and effect of creating a false appearance of material fact that enabled the publication of artificially inflated financial statements by the public corporation, but where Respondents themselves made no public statements concerning those transactions.

STATEMENT PURSUANT TO RULE 26.9

Petitioner's corporate disclosure statement was set forth on page ii of its Petition for a Writ of Certiorari. There are no amendments to that statement.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit (Pet. App. 1a-11a) is reported at 443 F.3d 987 (8th Cir. 2006). The orders of the district court dismissing claims against Respondents (Pet. App. 30a-71a) and denying reconsideration and leave to amend (Pet. App. 15a-29a) are unreported.

JURISDICTION

The opinion and order of the Court of Appeals was entered on April 11, 2006. A petition for a writ of certiorari was filed on July 7, 2006. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTE AND REGULATION INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * *
>
> To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5, states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

Petitioner appeals from a decision of the Eighth Circuit Court of Appeals affirming the dismissal of Respondents from this putative class action brought on behalf of investors in the securities of Charter Communications, Inc. ("Charter") for violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (the "Exchange Act") and Rule 10b-5, 17 C.F.R. § 240.10b-5.

Petitioner contends that Respondents Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") (collectively, "Respondents") are primary violators of § 10(b) of the Exchange Act and Rule 10b-5(a) and (c) for their own deceptive acts in a scheme designed to inflate Charter's reported financial performance. Respondents' fraudulent conduct was as straightforward as it was blatant.

In 2000, Charter was facing a shortfall in anticipated revenue and cash flow relative to Wall Street expectations. To close this gap, Charter agreed to overpay Respondents by a total of $17 million for set-top boxes that it had already agreed to purchase from them at lower prices, if Respondents would use those additional funds to "purchase" unwanted advertising from Charter. To create a false appearance that these transactions were legitimate, Respondents: (i) issued documentation falsely stating that Respondents demanded the price increases because of higher costs; (ii) falsely backdated contracts; and (iii) agreed to "purchase" advertising at four to five times regular rates using Charter's funds.

These phony transactions had no business purpose whatsoever. Their only purpose was to artificially inflate Charter's reported revenues and cash flow, and consequently the price of its stock.

Respondents' scheme was the subject of criminal proceedings by the United States Department of Justice ("DOJ"), as well as civil proceedings by the Securities and Exchange Commission ("SEC").

Section 10(b) prohibits the use, "directly or indirectly," of "any manipulative or deceptive device or contrivance in contravention" of SEC rules promulgated pursuant to the section. The issue on appeal is whether Respondents' conduct constitutes a "deceptive device or contrivance" violating SEC Rule 10b-5(a) prohibiting employment of "any device, scheme or artifice to defraud" and (c) making it unlawful to "engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person."

This Court has said that Congress crafted § 10(b) as a catchall provision to prohibit all fraudulent conduct in connection with the purchase or sale of securities, no matter how novel or unique. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971). The scheme alleged here,

however, is little more than a garden variety fraud and falls squarely within the prohibitions of the plain language of § 10(b) and Rule 10b-5.

Flagrant frauds such as the scheme perpetrated by Respondents led Congress to draft the federal securities laws following the stock market crash of 1929. Congress enacted this comprehensive set of statutes to promote investor confidence in our securities markets, which is essential to capital formation and our country's economy.

Facts[1]

Charter is a cable operator that provides video, data, interactive and private business network services to millions of customers across the country through its broadband network of coaxial and fiber-optic cable. J.A. 23a, SAC ¶ 25; Respt. App. 7-8, AC ¶ 22. During the class period it had almost 300 million shares of common stock outstanding which traded on the Nasdaq National Market. *Id.*

Defendants in addition to Respondents were Charter, certain of its executives and Charter's independent auditors. J.A. 23a-26a, SAC ¶¶ 25-36, 39; Respt. App. 7-10, AC ¶¶ 22-33, 36. The claims against all defendants other than Respondents were settled for $146.5 million prior to the district court's ruling on Respondents' motion to dismiss the Amended Complaint. *In re Charter Communications, Inc. Sec. Litig.*, No 4:02-CV-1186, 2005 U.S. Dist. LEXIS 14772, at *30 (E.D. Mo. June 30, 2005).

Respondents at relevant times were public corporations familiar with financial reporting principles and cable industry accounting conventions. J.A. 55a, SAC ¶¶ 98-99. They were

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1. Paragraph references are to the Amended Complaint ("AC"), printed as an appendix to Respondent Scientific-Atlanta's Opposition to Petition for Writ of Certiorari, and to the Second Amended Complaint ("SAC"), printed in the Joint Appendix.

each major manufacturers of electronic equipment, including digital set-top boxes for the cable industry. J.A. 26a, SAC ¶¶ 37-38; Respt. App. 10, AC ¶¶ 34-35. A digital set-top box is equipment that is placed on a subscriber's television enabling it to receive and view digital television signals. *Id.* Charter purchased set-top boxes from Respondents and supplied them to customers of its cable services. *Id.*

During the late 1990s, cable companies incurred substantial expenses installing cable networks, and it was not unusual for expenses to exceed revenues. J.A. 30a-31a, SAC ¶ 50; Respt. App. 11, AC ¶ 40. Consequently, stock market analysts valued cable companies based upon whether they were achieving significant growth in revenues, indicating increasing market share, and cash flow, rather than more traditional earnings measures. *Id.*

Charter announced its operating results and projections on a quarterly basis in press releases and during conference calls with analysts. *See, e.g.*, J.A. 78a-79a, SAC ¶¶ 146, 147; Respt. App. 49-50, AC ¶¶ 114, 115. Charter management viewed meeting analysts' expectations as critical to maintaining its stock price. J.A. 52a, SAC ¶ 91; Respt. App. 32, AC ¶ 76.

The pleadings allege various fraudulent practices engaged in by Charter during the class period to present a false picture of financial growth and success. J.A. 35a-53a, SAC ¶¶ 58-126; Respt. App. 15-38, AC ¶¶ 48-94. With respect to Respondents, the relevant time frame is the latter part of 2000. J.A. 52a-61a, SAC ¶¶ 90-114; Respt. App. 31-34, AC ¶¶ 75-82.

In August 2000, Charter recognized that it would not meet Wall Street analysts' revenue and operating cash flow projections. J.A. 52a, SAC ¶ 91; Respt. App. 32, AC ¶ 76. A shortfall would devastate the price of Charter's common stock. J.A. 102a, SAC ¶ 195; Respt. App. 69-70, AC ¶ 163. To avoid that outcome, Charter approached each of the Respondents and requested that it purchase advertising on Charter's cable

networks. J.A. 52a-53a, SAC ¶ 92. Respondents had never purchased advertising from Charter before, and they declined to do so with their own money. *Id.*

Charter then devised a scheme to give Respondents the money to "purchase" advertising from Charter. J.A. 54a, SAC ¶ 97. Critically, the scheme could not be accomplished without the active involvement of Respondents and their own deceptive acts. J.A. 55a-58a, SAC ¶¶ 100, 102, 104.

Pursuant to the scheme, Charter would *overpay* each Respondent $20 for each set-top box that it purchased, so long as Respondents used those funds to buy advertising from Charter. J.A. 54a, SAC ¶ 97. These agreements had no legitimate business purpose. J.A. 53a, SAC ¶ 93; Respt. App. 32, AC ¶ 77. At the time, Charter already had in place long-term contracts with Respondent Scientific-Atlanta to purchase set-top boxes at lower fixed prices covering its needs into 2002. J.A. 53a-54a, SAC ¶¶ 94-95. Despite these contracts, however, Charter agreed to pay Scientific-Atlanta $20 additional for each set-top box not only for future purchases, but on all pre-existing unfilled orders for purchases through the end of 2000. J.A. 54a, SAC ¶ 97.

In order to get these transactions past Charter's auditors and reflected in the financial statements Charter would issue to the public, Charter and Scientific-Atlanta agreed to fabricate a justification for the price increase. J.A. 55a-56a, SAC ¶ 100. A Charter executive requested that Scientific-Atlanta send it a false "pricing increase notification letter" stating:

> 1. The reason for the price increase and the date (09/01/00) of the increase.
>
> 2. A description of the quantities of set-tops this letter cover (the anticipated number of set-tops (351,180) that S-A expects to ship and Charter expects to take delivery of between 09/01/00 and 12/31/00[)].

3. A penalty provision in case Charter doesn't accept the anticipated number of set-tops in the specified time frame.

J.A. 55a-56a, SAC ¶ 100.

The sham "advertising" was discussed in this same communication, confirming that it was related to and intertwined with the set-top box price increases. *Id.* (stating "I will be sending the advertising contract for review prior to the particulars being worked out.").

As a willing partner in the scheme, Scientific-Atlanta submitted documentation to Charter falsely attributing the price change to "increased manufacturing" costs. J.A. 57a, SAC ¶ 102.

Charter similarly agreed to pay Motorola inflated prices for set-top boxes in exchange for Motorola funneling the extra charges back to Charter for "advertising." J.A. 57a-58a, SAC ¶¶ 103, 105.

Again, there was no legitimate business purpose for this agreement. J.A. 53a, SAC ¶ 93; Respt. App. 32, AC ¶ 77. In December 1999, Charter secured a contract to purchase 1,000,000 set-top boxes from Motorola at fixed prices for the 24-month period covering 2000 to 2001. J.A. 53a, SAC ¶ 94. In early fall 2000, however, Charter agreed to purchase 540,000 units from Motorola in the four-month period from September 1, 2000 to December 31, 2000, paying an additional $20 per unit. J.A. 57a, SAC ¶ 103. The 540,000 units represented the total amount that Charter expected to purchase for all of 2001. J.A. 57a-58a, SAC ¶ 104.

This new agreement provided that Charter would pay Motorola the additional $20 per unit even if Charter decided not to purchase the set-top boxes. J.A. 57a-58a, SAC ¶¶ 103-104. This enabled Motorola to pay for the "advertising." *Id.*

Charter informed Respondents that in order to deceive Charter's accountants, they had to create the appearance that there was no relation between the set-top box price increase agreements and the advertising contracts. Indictment, *United States v. Barford*, No. 4:03 CR 00434 (E.D. Mo. July 24, 2003), at ¶ 23 (*available at* http://www.usdoj.gov/dag/cftf/chargingdocs/charterindictment.pdf);[2] *see also* J.A. 55a-56a, SAC ¶ 100. Therefore, there would have to be separate contracts covering the transactions. *Id.* Accordingly, simultaneously with the new agreements for the set-top boxes, Charter and each of the Respondents entered into agreements entitled "Spot Telecasting and Digital Marketing Support Fee Agreements." J.A. 58a, SAC ¶ 106. The amounts Respondents agreed to pay for the advertising were exactly equal to the overpayments that Charter made to Respondents: Motorola would pay $10,800,000 and Scientific-Atlanta $6,730,000. J.A. 56a, SAC ¶ 101.

Further underscoring the lack of legitimacy of the advertising agreements, Respondents agreed to pay rates that were four to five times more than Respondents customarily paid for similar advertising elsewhere. J.A. 58a, SAC ¶ 106. Respondents were unwilling to purchase advertising with their own money even at prevailing rates, and were willing to pay these inflated rates only because Charter was footing the bill. *Id.*

The contracts with Respondents for the set-top box price increases as well as the advertising were not finalized until late

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2. The indictment is discussed in detail and incorporated by reference into the Second Amended Complaint. J.A. 59a-60a, 101a-02a, SAC ¶¶ 110, 194-95. Moreover, this Court can take judicial notice of the indictment and SEC litigation and administrative releases regarding the investigations alleged in the Second Amended Complaint because they are public records. *See Papsan v. Allain*, 478 U.S. 265, 269 (1986) (on review of a decision on a motion to dismiss, the Court is "not precluded from taking notice of items in the public record").

September 2000. J.A. 59a, SAC ¶ 107. Nonetheless, in order to create the false impression that the contracts were unrelated, Respondents agreed to, and executed, set-top box contracts backdated to August. J.A. 59a-60a, SAC ¶ 110.

As Respondents well understood, the sole purpose of their deceptive conduct was to further the scheme to overstate Charter's revenue and operating cash flow in financial statements which were filed with the SEC and issued to the investing public. J.A. 18a-19a, SAC ¶¶ 7, 10. When the true facts became known concerning these transactions, Charter's financials were restated to properly reflect economic reality (J.A. 98a, SAC ¶¶ 186-88; Respt. App. 66-67, AC ¶¶ 154-56), and the market price of its securities declined substantially. J.A. 94a-97a, SAC ¶¶ 178-79; Respt. App. 63-64, AC ¶¶ 146-47.

The district court dismissed the claims against Respondents, holding that they were not primary violators of § 10(b) and Rule 10b-5 as Petitioners had alleged, but rather were aiders and abettors of Charter in its violation of § 10(b). Accordingly, the district court held that the claims against Respondents were barred by this Court's holding in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 191 (1994). Pet. App. 69a. The court also denied Petitioner's motion to amend the complaint to plead additional facts on the ground that it would be futile because the amendment was based on the same legal claim which the court found unsustainable. Pet. App. 28a.

The Court of Appeals affirmed the district court's dismissal of the claims, holding that the language of § 10(b) making it unlawful for "any person" to "use or employ" "directly or indirectly" "any . . . deceptive device or contrivance" in connection with the purchase or sale of securities was constricted by this Court's decision in *Central Bank* to prohibit "only the making of a misstatement or a failure to disclose by one who

has a duty to disclose." Pet. App. 5a.[3] The court concluded that absent such a statement or failure to disclose, Respondents' conduct amounted to that merely of aiders and abettors, and the claims against them were foreclosed by *Central Bank*. Pet. App. 10a.

In reaching this conclusion, the Court of Appeals erroneously characterized Respondents' arrangements with Charter as "arm's length business transactions." *Id.* The SEC and the DOJ viewed them differently, as should this Court.

An indictment brought by the United States Attorney for the Eastern District of Missouri against two of Charter's officials who devised the scheme alleged, *inter alia*, that there were "no real economic benefits to either of these suppliers or to Charter" because "Charter would be using its own funds to purchase the advertising from itself." Indictment, *United States v. Barford*, at ¶ 18.

As part of a plea agreement, one of these defendants stipulated that "[t]he purpose of this transaction was not to confer an economic benefit on these suppliers or on Charter, but rather to increase Charter's reported revenue and cash flow." *United States v. Barford*, SEC Litig. Release No. 19,240 (May 26, 2005).

Similarly, in an SEC Order Instituting Cease and Desist proceedings against Charter, the SEC made a finding that:

> In reality, no real revenue was generated from these transactions because Charter provided the suppliers

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3. The Court of Appeals affirmed the district court's refusal to permit the filing of a Second Amended Complaint which sets out with substantial specificity Respondents' deceptive acts in furtherance of the scheme. The Court of Appeals noted that the "Complaint is factually detailed, as it must be to satisfy the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995." Pet. App. 3a. It held, however, that the amendments would be futile because they could not meet the limited reading of the statute under its decision. *Id.* at 11a.

> with the money they used to purchase the advertising services from Charter.

In re Charter Communications, Inc., SEC Exchange Act Release No. 50,098 (July 27, 2004) at ¶¶ 3, 13.

Further, the SEC found that the advertising contracts "were not undertaken at the fair value of the time slots purchased because these set-top box suppliers paid four to five times more for their advertisement time slots than other parties had paid Charter for advertisement time slots during 2000." *Id.* at ¶ 14.

At the time that Respondents were engaging in phony transactions with Charter, they were doing virtually the same thing with Adelphia Communications Corporation ("Adelphia"). *See* J.A. 60a, SAC ¶¶ 111-12 (Adelphia executive testified that its sham transactions were "Charter like"). In separate proceedings, the SEC obtained Cease and Desist Orders against Motorola and two executives of Scientific-Atlanta. *See In re Haislip*, SEC Exchange Act Release No. 54,030 (June 22, 2006); *In re Eidson*, SEC Exchange Act Release No. 54,031 (June 22, 2006); *In re Motorola, Inc.*, SEC Exchange Act Release No. 55,725 (May 8, 2007). As it noted in its complaint against Scientific-Atlanta, the SEC targeted these claims because they involved much larger sums of money. Complaint, *SEC v. Scientific-Atlanta, Inc.*, No. 06 Civ. 4823 (S.D.N.Y. June 22, 2006), at ¶¶ 35-36 (*available at* http://www.sec.gov/litigation/complaints/2006/comp19735.pdf); *see also* J.A. 60a, SAC ¶ 112. The SEC orders and complaint found that Respondents' transactions with Adelphia were shams and that it was obvious to Respondents that Adelphia would misuse the results of the transactions in financial reports.

Although these proceedings against Respondents concluded subsequent to the Eighth Circuit's decision, they are reflective of the views of an expert agency charged with the responsibility

of enforcing the securities laws that transactions like those at issue here are not legitimate arm's length transactions.[4]

Moreover, if the claims against Respondents had not been dismissed below, their conduct with Adelphia would have been probative of their scienter in their transactions with Charter.

SUMMARY OF ARGUMENT

Respondents' conduct was unlawful under the plain language of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Section 10(b) makes it unlawful for "any person, directly or indirectly" to "use or employ," in connection with the purchase or sale of securities, "any . . . deceptive device or contrivance" in violation of implementing SEC regulations.

It is impossible to see how Respondents' scheme with Charter can be described as anything other than a "deceptive device or contrivance." Respondents engaged in a series of sham transactions; they then falsified documents in order to conceal the true nature of those transactions. They did all this for the purpose of inflating the price that purchasers would be willing to pay for Charter's stock – thus acting "in connection with the purchase or sale" of securities. Respondents' conduct fits easily within the terms of Rule 10b-5 as well: they "employ[ed] a[] device, scheme or artifice to defraud" and they "engage[d] in" a number of "act[s]" and "practice[s]" that "operate[d] as a fraud or deceit."

There was no legitimate business purpose for these transactions, and none of them was "arm's length." Rather, they were artifices for Respondents to receive funds from Charter for them to funnel back to Charter. The "advertising" contracts called for Respondents to pay four to five times ordinary rates.

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4. The Amended Complaint referenced the ongoing investigation of Scientific-Atlantic by the DOJ and the SEC. Respt. App. 34, AC ¶ 82. *See also* J.A. 60a, SAC ¶¶ 111-12.

And to assure that these deceptive arrangements would be reflected in Charter's financial statements, Respondents themselves falsified documents. The scheme had the intended purpose and effect.

While this Court has repeatedly stated that Section 10(b) and Rule 10b-5 should be read flexibly to give effect to Congress's intent that they serve a remedial purpose and "catchall" function, the facts of this case do not require an expansive reading of these provisions. Respondents' conduct violates the plain language of the statute and Rule under *any* natural reading.

The Court of Appeals rewrote the statute. Section 10(b) – conspicuously unlike other provisions of the securities laws – is not limited to "misstatements," a word that does not appear in the section. Congress instead chose the phrase "any ... deceptive device or contrivance." That inclusive phrase was obviously chosen to reach beyond verbal misrepresentations by covering conduct designed to convey false information. The breadth of the prohibition is again confirmed by Rule 10b-5, which reaches not just false statements (Rule 10b-5(b)) but "any device, scheme, or artifice to defraud" (Rule 10b-5(a)) and "any act, practice or course or business which operates or would operate as a fraud or deceit upon any person" (Rule 10b-5(c)).

The contrast between Section 10(b) and other provisions of the securities laws – which are expressly limited to misstatements – shows that Congress's choice of expansive words, going beyond "misstatements," was not inadvertent. In Section 11 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77k, the same 73rd Congress that enacted § 10(b) limited liability to only a certain class of persons, only for misstatements and omissions and only for a registration statement filed with the SEC covering the issuance of securities. Section 12(a)(2) of the Securities Act, 15 U.S.C. § 77l(a)(2), is similarly worded.

Certainly, if Congress had intended to limit the reach of § 10(b) it would have included similar express restrictions. The Court made the point clearly in distinguishing between the narrow scope of § 11 and the broad contours of § 10(b) in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

The Court of Appeals sought to justify its conclusions by asserting that imposing "liability for securities fraud on one party to an arm's length business transaction in goods and services other than securities because that party knew or should have known that the other party would use the transactions to mislead investors in its stock would introduce potential far reaching duties and uncertainties" for such parties. Pet. App. 10a. The Court of Appeals, however, mischaracterized this case. This is not a case involving an "arm's length transaction" in which a party acted honestly but perhaps with knowledge that the transaction would be used to mislead investors. This is a case in which Respondents themselves engaged in fraud. Respondents engaged in transactions that they knew were shams, and Respondents then lied about those transactions. No "far reaching duties and uncertainties" will be introduced if the decision below is reversed; any party will be able to avoid liability by simply not engaging in its own deceptive conduct.

Respondents' deceptive acts had the purpose and effect of furthering the fraudulent scheme. Their active participation was material to its accomplishment and the consequences foreseeable. The results were published in Charter's financial statements with the expected result of inflating the price of its securities.

In *Central Bank*, the Court recognized that "[i]n any complex securities fraud, . . . there are likely to be multiple [primary] violators," and further recognized that "[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability." 511 U.S. at 191. *Central Bank* did not address whether a primary violation for a deceptive scheme or course of conduct

is proscribed for secondary actors under Rule 10b-5(a) or (c) since that issue was not before the Court. Rather, in *Central Bank*, the plaintiff conceded that the defendant had not committed any deceptive acts itself but had only facilitated a fraud perpetrated by others.

The scheme perpetrated on Charter's investors could not have been accomplished by Charter acting alone. It required willing participants – not bystanders merely allowing the fraud to occur or facilitating it by non-deceptive conduct, but partners who would perform their own deceptive acts to enable the scheme to achieve its intended purpose. Charter found those partners in Respondents, and they must not be "free from liability." 511 U.S. at 191.

Lawsuits on behalf of investors defrauded by such conduct pose no threat to legitimate business people. Sham transactions and fraudulent paper trails do not pass muster under any notion of how legitimate business is to be transacted. Not only do they result in financial losses – sometimes ruinous – for innocent investors, but they corrode and undermine the integrity of our markets, impede effective capital formation and negatively impact the economy. These are evils that § 10(b) was designed to prevent.

Legitimate business will be unaffected if the Court adopts a test giving effect to the plain text of Section 10(b) and Rule 10b-5, but going no further. One proposed test would be that: a person engages in a deceptive act as part of a scheme to defraud investors, and violates Section 10(b) and Rule 10b-5(a) and/or (c), if the purpose and effect of his conduct is to create a false appearance of material fact in furtherance of that scheme.

The Court of Appeals' circumscribed reading of § 10(b) is also inconsistent with the amendments to the Exchange Act enacted by Congress in the Private Securities Litigation Reform Act of 1995, Pub. L. 104-69, 109 Stat. 737 (Dec. 22, 1995) ("PSLRA"). In response to perceived abuses in securities fraud

class actions, Congress imposed a variety of conditions to the maintenance of such suits. However, it did nothing to limit the substantive prohibitions of the statute. Indeed, recognizing that there may be multiple actors in a securities fraud, Congress imposed a system that made each actor responsible only for its proportionate share of damages absent a knowing violation. Proportionate liability explicitly acknowledges that secondary actors may be liable as primary violators.

The PSLRA's tests for determining when to apply proportionate liability are instructive. Congress set forth one test related to conduct consisting of false and misleading statements, and one test related to other "conduct," reflecting the full range of "deceptive devices" prohibited by Section 10(b). *See* 15 U.S.C. § 78u-4(f)(10). Similarly, in the Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227 (Nov. 3, 1998) ("SLUSA"), Congress reiterated its understanding that deceptive conduct involves more than just misstatements and omissions when it used those terms in the disjunctive. *See* 15 U.S.C. § 78bb(f)(5)(E).

Extensive Congressional hearings and debates preceded the enactment of the PSLRA and SLUSA. While the amendments to the securities laws protect against nonmeritorious suits and awards disproportionate to wrongdoing, Congress recognized the important role that meritorious suits play to protect the integrity of our markets. If a change is to be made to the substantive law, it should be made by legislative action. The Court of Appeals relegated this task to itself, and the decision should be reversed.

ARGUMENT

I. Schemes To Defraud Are Prohibited by the Plain Language of Section 10(b) and Rule 10b-5.

Congress enacted the Securities Exchange Act of 1934 to "'insure honest securities markets and thereby promote investor confidence' after the market crash of 1929." *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (quoting *United States v. O'Hagan*, 521 U.S. 642, 658 (1997)). Section 10(b) is a key provision of the 1934 Act, making it unlawful for "any person, directly or indirectly" to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b). Congress intended Section 10(b) to be a "catchall" provision to prevent the full range of "cunning devices" used to defraud investors. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-03 (1976). Although it has amended the Exchange Act several times since 1934, Congress has steadfastly refused to narrow the plain text of Section 10(b).

This Court has recognized the "important part" that Section 10(b) and Rule 10b-5 play in the "federal regulation of vital elements of our economy." *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 126 S. Ct. 1503, 1509 (2006). "The magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." *Id.*

Despite the clear language and important purpose of Section 10(b) and Rule 10b-5, the Court of Appeals refused to apply the statute and rule as written. Instead, citing policy concerns, the court below imposed limitations that were never enacted by Congress or promulgated by the SEC, and that had no basis in the language of Section 10(b) or Rule 10b-5. Statutes must be interpreted as written, even if a court deems the policies adopted by Congress unwise or outdated: "'Whatever temptations the statesmanship of policy-making might wisely suggest,' the judge's job is to construe the statute – not to make it better."

Jones v. Bock, 127 S. Ct. 910, 921-22 (2007) (quoting Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 533 (1947)); *see also Central Bank*, 511 U.S. at 188 ("Policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it.") (citation omitted).

A. Deceptive Devices and Contrivances Prohibited by the Plain Text of Section 10(b) Include Schemes to Defraud.

"'[T]he starting point in every case involving construction of a statute is the language itself.'" *Ernst & Ernst*, 425 U.S. at 197 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)). The Court has specifically emphasized "[a]dherence to the text in defining the conduct covered by § 10(b)." *Central Bank*, 511 U.S. at 174. The text of Section 10(b) prohibits "any . . . deceptive device or contrivance" by "any person, directly or indirectly." 15 U.S.C. § 78j(b). Because these words are unambiguous, "the judicial inquiry is complete." *Desert Palace, Inc. v. Costa*, 539 U.S. 90, 98 (2003) (citation and quotation omitted).

The Court of Appeals refused to give effect to the plain text enacted by Congress. Instead, it treated Section 10(b) as if it were limited to only direct misrepresentations or omissions. However, that is not how Congress drafted the statute. Section 10(b) does not even mention misrepresentations or omissions, let alone specify that its scope is limited to only those particular forms of deceptive conduct. As the Court noted in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983), the broad language of Section 10(b) contrasts markedly with other sections of the securities laws that are "limited in scope."

Congress's refusal explicitly to limit Section 10(b) to misrepresentations and omissions should not be cast aside

as a mere oversight. In *Central Bank*, this Court reasoned that if Congress had intended to include aiding and abetting liability in Section 10(b), it would have done so explicitly. 511 U.S. at 177. The same fidelity to statutory text should apply here.

Congress knew how to limit sections of the securities acts to misrepresentations and omissions when it chose to do so. In each section it intended to be restricted, Congress invoked a specific limiting phrase. *See* Securities Act §§ 10, 11, 12 and 17 and Exchange Act § 14(e) (all prohibiting the making of "any untrue statement of a material fact or [the omission of] any material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading"). Congress's decision to reject this language in Section 10(b) indicates that it did not intend Section 10(b) to be similarly restricted. *See United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 n.5 (1989) (where Congress used a specific phrase to restrict the scope of bankruptcy code provisions, it would be "inconsistent" to similarly restrict provisions cast in broader terms).

The actual terms of Section 10(b) unquestionably reach those who defraud investors indirectly via a scheme. As this Court explained in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), "'§ 10 (b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'" *Id.* at 11 n.7 (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)) (emphasis in original).

Section 10(b) covers deceptive conduct by "any person," whether "directly or indirectly." 15 U.S.C. § 78j(b). Congress's use of the term "any" was "obviously meant to be inclusive." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972). "Directly" means "without anything intervening; personally." *Webster's International Dictionary* 738 (2d ed.

1934). "Indirectly" means "not directly." *Id.* at 1267. Thus, all those who engage in deceptive conduct in connection with the purchase or sale of securities violate Section 10(b), even if the fraud is accomplished as part of a greater scheme.[5]

In *Ernst & Ernst v. Hochfelder*, the Court made clear that the words "device" and "contrivance" each incorporate schemes to defraud, as are at issue in this case. 425 U.S. at 199 n.20. Citing *Webster's International Dictionary* (2d ed. 1934), the Court defined "device" to mean "[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice," and defined "contrivance" to mean "[a] thing contrived or used in contriving; a ***scheme, plan, or artifice***." *Id.* (emphasis added).[6]

While the Court has not expressly defined the adjective "deceptive" in the context of Section 10(b), it has indicated how that word should be construed. "[L]egislation when not expressed in technical terms is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him." *Id.*, 425 U.S. at 199 n.19 (citation and quotation omitted). Absent an indication that Congress intended the words of a statute to bear some different import,

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5. Petitioner acknowledges that the term "directly or indirectly" does not reach those who did not themselves engage in a deceptive act, but merely aided or abetted a violation by another. Here, Respondents themselves are alleged to have engaged in deceptive practices. *Cf. Central Bank*, 511 U.S. at 176 (stating that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity").

6. The terms "employ" and "use" also defy restriction. "Employ" is a synonym for the verb "use," *Webster's International Dictionary* 839 (2d ed. 1934), which means "to engage in" or "to put into operation," *id.* at 2806. Both verbs focus exclusively on the conduct of the violator and do not require any particular relationship with those injured by the conduct.

they should be given their "'ordinary, contemporary, common meaning.'" *Williams v. Taylor*, 529 U.S. 420, 431 (2000) (quoting *Walters v. Metro. Educ. Enters., Inc.*, 519 U.S. 202, 207 (1997)).

The "ordinary, contemporary, common meaning" of "deceptive" easily encompasses schemes to defraud and fraudulent business practices. The same dictionary used in *Ernst & Ernst* "defines 'deceptive' as '[t]ending to deceive; having power to mislead.'" *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 502 (S.D.N.Y. 2005). The scheme to defraud here, using sham transactions and false and backdated documents to cause the publication of artificially inflated financial statements to investors, falls squarely within this definition.[7]

Congress itself recognized that the term "deceptive conduct" embraced more than just misrepresentations and omissions in the PSLRA. It set forth two separate tests to define a "knowing violation" for purposes of determining proportionate liability, *one for misrepresentations and omissions, and one for other "conduct."*[8] Section 21D(f)(10), 15 U.S.C. § 78u-4(f)(10). Had Congress understood "deceptive devices" to be limited to just misrepresentations and omissions, it would not have included

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7. The legal meaning of "deception" similarly includes Respondents' scheme to defraud. That term embraces all "intentional misleading by falsehood," whether "spoken or acted." *Black's Law Dictionary* 529 (3d ed. 1933).

8. Similarly, in SLUSA, Congress referred to misrepresentations and omissions in the disjunctive from other "deceptive conduct," 15 U.S.C. § 78bb(f)(5)(E), indicating that it intended to give each term separate meaning. *See Dole Food Co. v. Patrickson*, 538 U.S. 468, 476-77 (2003) (statutes should be construed, if possible, so that "every word has some operative effect") (citation and quotation omitted). Congress's use of "deceptive" in Section 10(b) should also be given independent meaning. *Dabit*, 126 S. Ct. at 1513 ("identical words used in different parts of the same statute are . . . presumed to have the same meaning") (citation and quotation omitted).

a test for other "conduct." The Act should be construed to give both tests meaning. *Dole Food*, 538 U.S. at 476-77.

Congress's decision to enact detailed proportionate liability provisions also indicates that it "clearly anticipated the continued liability of secondary defendants." Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liablility Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1313 (June 1999). Such provisions are of "limited importance unless the general standard of liability holds collateral defendants responsible" for their own fraudulent conduct. *Id. See also* 15 U.S.C. § 78u-4.

The requirement that the deceptive device or contrivance be used or employed "in connection with" the purchase or sale of securities cannot limit the scope of Section 10(b) to direct misrepresentations or omissions. The Court has consistently adopted a broad reading of this language. *See Dabit*, 126 S. Ct. at 1509; *O'Hagan*, 521 U.S. at 658; *Zandford*, 535 U.S. at 819-22. In *Zandford*, the Court held that conduct is "in connection with" the purchase or sale of securities so long as the alleged fraud "coincided" with securities transactions. *Id.* at 819-20, 822.

The "in connection with" language is more than satisfied here. Respondents' conduct served only to conceal the fact that Respondents were taking money from Charter with one hand and handing the same funds back to Charter with the other, causing false financial statements to be published to investors and artificially lifting the price of Charter's stock. *See, e.g.*, J.A. 52a-61a, SAC ¶¶ 91-114. Thus, Respondents' deceptive conduct more than coincided with investors' purchases of Charter securities; it caused the purchases to be made at inflated prices. *See Zandford*, 535 U.S. at 820-22.

The Court of Appeals may have disagreed with the broad language employed by Congress in Section 10(b), or the remedies Congress selected to prevent litigation abuses, but it

was not free to substitute its own judgment for that of the legislature. *Jones v. Bock*, 127 S. Ct. at 921-22. Section 10(b) must be construed as written, and it undeniably embraces the scheme to defraud alleged in this case.

B. The Plain and Unambiguous Language of Rule 10b-5 Prohibits Schemes to Defraud.

Congress granted the Securities and Exchange Commission the authority to define the scope of prohibited activity within the confines of Section 10(b). *See* 15 U.S.C. § 78j(b) (prohibiting only those "deceptive devices or contrivances" that contravene SEC rules). In response, largely drawing from the language of Section 17(a) of the Securities Act, the SEC promulgated Rule 10b-5. *Blue Chip Stamps,* 421 U.S. at 766-68 (Blackmun, J., dissenting) (discussing regulatory history).

Rule 10b-5 is broadly worded to implement all of the authority granted to the SEC in Section 10(b). *See Zandford,* 535 U.S. at 816 n.1 ("The scope of Rule 10b-5 is coextensive with the coverage of § 10(b) . . ."). Rule 10b-5 proscribes three distinct categories of fraudulent conduct: (a) devices, schemes and artifices to defraud; (b) misrepresentations and omissions of material fact; and (c) acts, practices, and courses of business which operate as a fraud or deceit. 17 C.F.R. § 240.10b-5.

For several decades, this Court has recognized a private cause of action under Rule 10b-5 and Section 10(b). "The existence of this implied remedy is simply beyond peradventure." *Huddleston*, 459 U.S. at 380. The implied remedy "has become an essential component of the protection the law gives to investors who have been injured by unlawful practices." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 374 (1991) (Kennedy, J., dissenting). Congress ratified the implied remedy when it enacted the PSLRA, maintaining the cause of action but providing several procedural hurdles to prevent abusive litigation. *See Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1340 (11th Cir.), *cert.*

denied, 537 U.S. 950 (2002) (noting that Congress enacted the PSLRA mainly to address private §10(b) claims).

The SEC has consistently maintained that its Rule and Section 10(b) "include conduct beyond the making of false statements or misleading omissions, for facts can be misrepresented by action as well as words." Amicus Curiae Brief of the SEC filed Oct. 22, 2004 in *Simpson v. AOL Time Warner, Inc. (Calif. St. Teachers Ret. Sys. v. Homestore.com, Inc.)*, No. 04-55665 (9th Cir.), at 8.[9] The Commission correctly noted that a business partner "achieve[s] the same deception" by creating a false appearance of fact that becomes included in financial statements as it would by making a direct misrepresentation to shareholders. *Id.* Therefore, it has maintained that "liability should be equally available" against such parties. *Id.* The Commission's reasonable interpretation is consistent with the language of Section 10(b) and Rule 10b-5, and should be given deference. *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.16 (1988).

The Court of Appeals ignored the clear language of Rule 10b-5 and the SEC's reasonable interpretation thereof. Instead, it held that only the misrepresentations and omissions described in Rule 10b-5(b) were proscribed by the statute, effectively nullifying Rule 10b-5(a) and (c). *See* Pet. App. at 9a ("any defendant who does not make or cause to be made a fraudulent misstatement or omission . . . cannot be held liable under §10(b) or any subpart of Rule 10b-5."). The court below gave no reason for reading out of existence two thirds of Rule 10b-5.

The Eighth Circuit's judicial revision of Rule 10b-5 flies in the face of recent Congressional action. Congress has not only refused to limit Rule 10b-5 as the Court of Appeals did, but has expressly extended Rule 10b-5, including all subparts.

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9. The Department of Justice took the same position in *O'Hagan*. *See* Reply Brief of the United States, 1997 U.S. S. Ct. Briefs LEXIS 144, at *7 (April 9, 1997) ("a course of conduct that is fraudulent is also deceptive, for the concept of fraud inherently includes deception.").

In 2000, Congress amended Section 10(b) to provide that the prohibitions of Rule 10b-5 apply to securities-based swap contracts, as well as purchases and sales of securities. Pub. L. 106-554, 114 Stat. 2763 (Dec. 21, 2000). By extending Rule 10b-5, Congress indicated its approval of the rule as promulgated.

This Court's precedent also prohibits the appellate court's rewriting of Rule 10b-5. In *United States v. Naftalin*, 441 U.S. 768 (1979), the Court examined the virtually identical language of Section 17(a) of the Securities Act, upon which Rule 10b-5 was based. It held that all three parts should be given independent effect, rejecting the argument that the limitations of one subsection should be read as limiting other subsections. *Id.* at 773. Noting that "Congress did not write the statute that way," the Court explained:

> As is indicated by the use of an infinitive to introduce each of the three subsections, and the use of the conjunction "or" at the end of the first two, each subsection proscribes a distinct category of misconduct. n5 Each succeeding prohibition is meant to cover additional kinds of illegalities – not to narrow the reach of the prior sections. *See United States v. Birrell*, 266 F. Supp. 539, 542-543 (S.D.N.Y. 1967). There is, therefore, "no warrant for narrowing alternative provisions which the legislature has adopted with the purpose of affording added safeguards." *United States v. Gilliland*, 312 U.S. 86, 93 (1941).
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> n5 Moreover, while matters like "punctuation [are] not decisive of the construction of a statute," *Costanzo v. Tillinghast*, 287 U.S. 341, 344 (1932), where they reaffirm conclusions drawn from the words themselves they provide useful confirmation.

> Here the use of separate numbers to introduce each subsection, and the fact that the phrase "upon the purchaser" was set off solely as part of subsection (3), confirm our conclusion that "[nothing] on the face of the statute suggests a congressional intent to limit its coverage," *United States v. Culbert*, 435 U.S. 371, 373 (1978), to frauds against purchasers.

Id. at 774-75. The identical structure and virtually identical language employed in Rule 10b-5 require that each of its three subparts also be given independent meaning. *Id.*

II. The Court of Appeals Misread *Central Bank* and Ignored This Court's Subsequent Explanation.

The court below relied heavily on this Court's decision in *Central Bank*. But it is easy to see why this case is, at the most fundamental level, different from *Central Bank*: in this case, unlike *Central Bank*, the Respondents engaged in fraud. Respondents did not just facilitate or aid and abet Charter's fraud; they engaged in classic fraudulent behavior themselves. They participated in transactions that they knew to be shams, and they falsified records about those transactions. Respondents did this for the purpose and effect of corrupting the flow of information to investors. This is just the kind of conduct that the language of Section 10(b) and Rule 10b-5 forbids. Far from supporting Respondents, *Central Bank* – a decision based on scrupulous adherence to the language of Section 10(b) – is deeply inconsistent with Respondents' arguments.

From the very first line of *Central Bank*, this Court recognized that primary liability under Section 10(b) is not limited to just misrepresentations or omissions, but rather includes any "manipulative or deceptive act in connection with the purchase or sale of securities." 511 U.S. at 166. The Court of Appeals failed to consider whether the forged documents, false paper trail, and sham transactions generated by Respondents constituted "deceptive acts." Instead, focusing on

the following *dicta* from *Central Bank*, the Eighth Circuit concluded that *Central Bank* was intended to judicially restrict the plain text of Section 10(b):

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.

Pet. App. 6a (quoting *Central Bank*, 511 U.S. at 191).

While the Court of Appeals described the instant case as one that "tested the boundaries" of the "caveat" it quoted from *Central Bank*, it ignored the Court's direction in a subsequent decision, *O'Hagan*, not to draw undue conclusions from this very text. *Id.* In *O'Hagan*, this Court explained:

> The Eighth Circuit isolated the statement just quoted and drew from it the conclusion that § 10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely. *See* 92 F.3d at 619. It is evident from the question presented in *Central Bank*, however, that *this Court, in the quoted passage, sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under § 10(b) and Rule 10b-5 for certain conduct.*

521 U.S. at 664 (emphasis added).

The Eighth Circuit repeated its error in the decision below. It focused on the same *dicta* that this Court had already directed it not to view in isolation, as well as similar *dicta* stating that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Central Bank*, 511 U.S. at 177. Based on this *dicta*, and contrary to the Court's explanation elsewhere in *Central Bank* and again in *O'Hagan*, the Court of Appeals erroneously held that *Central Bank* was intended to narrow the plain language defining primary liability in Section 10(b) and Rule 10b-5. Pet. App. 5a-9a. As a result, it held that Respondents, who did not themselves make misrepresentations or omissions to investors, could be no more than aiders and abettors. *Id.*

The Eighth Circuit also ignored the critical factual differences between *Central Bank* and this case. *Central Bank* involved an indenture trustee who did not enter into sham transactions, did not falsify or backdate any contracts, did not engage in any misrepresentations, and did not itself create any false appearance of material fact. *First Interstate Bank, N.A. v. Pring*, 969 F.2d 891, 902-03 (10th Cir. 1992), *rev'd on other grounds sub nom. Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S.164 (1994). Nor did the trustee owe any duties to the plaintiffs in that case, who purchased bonds pursuant to a 1988 bond offering. While the plaintiffs contended that the indenture trustee could have required an independent audit under a separate 1986 bond offering that may have uncovered the fraud, the Indenture Trust Act of 1939 strictly limited the obligations of indenture trustees to those set forth in the indenture. Thus, no duty could have run to those plaintiffs based on the separate 1986 indenture. *First Interstate*, 969 F.2d at 903.

As this Court emphasized, the *Central Bank* plaintiffs "concede[d] that Central Bank did not commit a manipulative or deceptive act within the meaning of § 10(b)." 511 U.S. at 191. Instead, they claimed that the bank violated Section 10(b) without committing a deceptive act by recklessly aiding and

abetting the violation of another defendant. The plaintiffs in *Central Bank* argued that the indenture trustee provided "substantial assistance" by delaying the independent audit it was authorized but not required to undertake, supporting secondary liability. The question presented to this Court was whether "private civil liability under §10(b) extends . . . to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation." 511 U.S. at 167.

The facts presented in this case involve the exact opposite issue – whether Respondents should be liable under Section 10(b) ***for their own deceptive practices***. Petitioner has alleged in detail false documents prepared by *Respondents*, contracts backdated by *Respondents*, and sham transactions *Respondents* entered into with Charter, all of which created the false appearances of material fact that inflated Charter's published financial statements. Thus, unlike in *Central Bank*, Petitioner does not seek to "extend" civil liability under Section 10(b). Rather, it asks this Court to enforce Section 10(b) as written, prohibiting deceptive acts by "any person, directly or indirectly."

III. This Court Has Consistently Recognized That Schemes to Defraud Are Unlawful Under the Text of Section 10(b) and Rule 10b-5.

The decision below contradicts a long line of decisions of this Court both before and after *Central Bank* applying the broad text of Section 10(b) and Rule 10b-5. The Court has repeatedly stated that "securities legislation enacted for the purpose of avoiding frauds be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Ernst & Ernst*, 425 U.S. at 217 (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963)); *see also Bankers Life*, 404 U.S. at 12 (1971) (same); *Affiliated Ute*, 406 U.S. at 151 (same); *Huddleston*, 459 U.S. at 386-87 (same); *Central Bank*, 511 U.S. at 198 (same); *Zandford*, 553 U.S. at 819 (same).

In *Bankers Life*, the Court emphasized that "§ 10(b) bars the use of any deceptive device in the 'sale' of any security by 'any person.'" *Id.*, 404 U.S. at 10. Thus, it allowed an insurer defrauded in connection with the sale of its bond holdings to proceed with claims under § 10(b) and Rule 10b-5 against both the insider who sold the bonds and the "outside collaborators" who created the paperwork allowing him to misappropriate the proceeds. *Id. See also Central Bank*, 511 U.S. at 191 (recognizing that "there are likely to be multiple violators" in "any complex securities fraud.").

The Court has also repeatedly explained that Section 10(b) and Rule 10b-5 extend beyond misrepresentations and omissions. In *Affiliated Ute*, it stated that although "the second subparagraph of [Rule 10b-5] specifies the making of an untrue statement of a material fact and the omission to state a material fact," the "first and third subparagraphs are not so restricted." 406 U.S. at 152-53. *See also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 (1977) (listing "deception, misrepresentation, or nondisclosure" in the disjunctive, indicating that deception has some separate meaning); *accord Parmalat Sec. Litig.*, 376 F. Supp. 2d at 499; *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335-36 (S.D.N.Y. 2004).

In *Huddleston*, the Court confirmed that primary liability under Section 10(b) and Rule 10b-5 encompasses persons who caused misrepresentations to be made to investors, as well as those who actually made the misrepresentations. 459 U.S. at 387 n.22. Expressly limiting its opinion to primary liability, not aiding and abetting, *see id.* at 379 n.5, the Court explained that Section 10(b) "extends to 'any person' who engages in fraud in connection with a purchase or sale of securities," even where the statements ultimately conveyed to shareholders are not attributed to that person. *Id.* at 387 n.22.

Following *Central Bank*, this Court made clear that private claims may be brought for schemes to defraud as well as misrepresentations and omissions. *Wharf (Holdings) Ltd. v.*

United Int'l Holdings, Inc., 532 U.S. 588 (2001). Justice Breyer, writing for a unanimous Court, explained that:

> [R]ule [10b-5] forbids the use, "in connection with the purchase or sale of any security," of (1) "any device, scheme, or artifice to defraud"; (2) "any untrue statement of a material fact"; (3) the omission of "a material fact necessary in order to make the statements made . . . not misleading"; or (4) any other "act, practice, or course of business" that "operates . . . as a fraud or deceit." 17 CFR § 240.10b-5 (2000).
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> *To succeed in a Rule 10b-5 suit, a private plaintiff must show that the defendant used, in connection with the purchase or sale of a security, one of the four kinds of manipulative or deceptive devices to which the Rule refers,* and must also satisfy certain other requirements not at issue here.

Id. at 593 (emphasis added); *see also id.* at 594 (referring to "other conduct forbidden by the Rule" besides misrepresentations).

In *Zandford,* the Court reinforced the principle that Section 10(b) and Rule 10b-5(a) could be violated by conduct alone. *Id.*, 553 U.S. at 821. Upholding summary judgment against a broker for a scheme to defraud his customer in connection with sales of the customer's securities, the Court explained that "each time respondent 'exercised his power of disposition for his own benefit,' that conduct, 'without more,' was a fraud." *Id.* (citation and quotation omitted).

These decisions, which shaped the interpretation of § 10(b) and Rule 10b-5 over the course of decades, were largely ignored by the court below. When considered as a whole, this body of law confirms what this Court explicitly stated in *O'Hagan*: that *Central Bank* was not intended to limit the scope of primary liability for those who commit deceptive acts. The Court of Appeals erred in holding otherwise.

IV. Giving Natural Meaning to the Language of Section 10(b) and Rule 10b-5 Would Not Affect Legitimate Business.

The Court of Appeals expressed concern that imposing liability for securities fraud on parties to arm's length business transactions would introduce potential far-reaching duties and uncertainties. Pet. App. 10a. That proposition may be correct, but it is not implicated here. This case involves transactions which were anything but arm's length, and were far outside standard business norms.

Lying, forging documents, and creating false paper trails are not "uncertain" business practices that fall into a judicial gray area. Congress has determined that such deceptive acts, when committed in connection with the purchase or sale of securities, may be criminal. 15 U.S.C. § 78j(b).[10] Thus, Congress has left no doubt that participating in a fraudulent scheme is unlawful, and those who do so notwithstanding the criminal nature of their conduct should understand that compensation may be available to their victims.

The Eighth Circuit was required to adhere to the text of Section 10(b) even if it felt its broad scope was unwise. *Central Bank*, 511 U.S. at 188; *Jones v. Bock*, 127 S. Ct. at 921-22. The proper course of action was not to imply limitations rejected by Congress, but to craft an appropriate test consistent with the statutory language, reaching the conduct proscribed by Congress but going no further. One proposed test would provide that:

> *A person engages in a deceptive act as part of a scheme to defraud investors, and violates Section 10(b) and Rule 10b-5(a) and/or (c), if the purpose and effect of his conduct is to create a false appearance of material fact in furtherance of that scheme.*

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10. In many cases, these same acts will also constitute mail fraud in contravention of 18 U.S.C. § 1341 or wire fraud in contravention of 18 U.S.C. § 1343.

Any test adopted by the Court would be bolstered by the heightened pleading standards Congress imposed in the PSLRA. A plaintiff would be required to allege in detail not only the existence of a scheme to defraud, and each defendant's own deceptive conduct as part of that scheme, but also would need to plead specific facts giving rise to a strong inference of scienter. 15 U.S.C. § 78u-4(b)(2). Absent such a showing, defendants would not even be subject to discovery. 15 U.S.C. § 78u-4(b)(3). These pleading standards will protect against dubious suits as Congress intended. Legitimate business partners will be unaffected – only those who engage in their own deceptive conduct will face liability.

By focusing on the defendant's own deceptive conduct, the proposed test provides clear guidelines for business people. Those who themselves lie, forge documents or otherwise create false appearances of fact may face liability. Those who merely assist a scheme to defraud but do not commit their own fraudulent acts will, at most, be aiders and abettors, and will not face private liability.

Lower courts have demonstrated their ability to draw this distinction. In *Parmalat*, the district court sustained claims against defendants who created a false appearance of fact through sham factoring arrangements and the creation of misleading securitizations, but dismissed claims against banks that provided funding through various equity arrangements the plaintiff alleged supported the scheme to defraud, but where the banks did not themselves "use or employ a deceptive device or contrivance." 376 F. Supp. 2d at 504-05. In *Simpson*, after properly recognizing that Section 10(b) includes scheme liability, the Ninth Circuit affirmed dismissal of claims against business partners because the complaint failed to sufficiently allege that the business partners engaged in their own fraudulent conduct. *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1052-55 (9th Cir. 2006), *petition for cert. filed sub nom. Calif. St. Teachers Ret. Sys. v. Homestore.com, Inc.*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560).

The proposed test does not expose secondary actors to excessive liability. In the PSLRA, Congress enacted detailed proportionate liability provisions to ensure that a defendant is responsible only for its fair share of any damage award absent a knowing violation. *See* 15 U.S.C. § 78u-4. Accordingly, while raising the specter of vast liability may serve Respondents' strategic interests in this appeal, such fears are unfounded and cannot justify deviating from the clear language of Section 10(b) and Rule 10b-5.

V. Undermining the Plain Language of Section 10(b) and Rule 10b-5 Would Harm Markets and Create a Blueprint for Fraud.

Eliminating recourse against those who engage in schemes to defraud investors would undermine investor confidence and create a moral hazard encouraging fraud. Academic studies have determined that U.S.-listed companies enjoy substantial economic benefits because of the great trust investors place in our regulatory scheme. They are afforded richer valuations than their foreign-listed peers,[11] and have a significantly lower cost of capital.[12] Exposing investors to schemes to defraud would endanger confidence and imperil those savings.

Congress has recognized that private securities litigation is "an indispensable tool," helping to "promote public and global confidence in our capital markets" by helping to deter wrongdoing. Conference Report on Securities Litigation Reform, H.R. Rep. No. 104-369, 1995 U.S.C.C.A.N. 730 (Nov.

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11. Craig Doidge, G Andrew Karolyi, and Rene M. Stulz, *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices over Time*, (Apr. 2007) (*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982193).

12. Charles D. Niemeier, *American Competitiveness in International Capital Markets* (Public Company Accounting Oversight Board, Sept. 30, 2006) (*available at* http://www.pcaobus.org/News_and_Events/Events/2006/Speech/09-30_Niemeier.aspx).

28, 1995). Similarly, the Court has repeatedly stated that private securities actions "provide 'a most effective weapon in the enforcement' of the securities laws and are a 'a necessary supplement to Commission action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)); *see also Lampf, Pleva*, 501 U.S. at 376 (Kennedy, J., dissenting) (quoting *Basic* for the proposition that "private § 10(b) suits constitute 'an essential tool for enforcement of the 1934 Act's requirements'").[13]

For these reasons, in 1995 and again in 1998, Congress chose to address potential nonmeritorious securities actions entirely through a series of procedural reforms as well as limitations on joint and several liability. It elected to maintain the broad text of Section 10(b).

The decision below, in addition to rewriting the statute, creates a moral hazard that is deleterious to investors. If the decision stands, companies will quickly learn that they can get away with fraud by compartmentalizing the creation of a false appearance of material fact from the ultimate reporting of false information to investors. If senior management keeps themselves sufficiently removed from the details of the scheme, relying on their lieutenants to "outsource" the fraudulent acts, neither the issuer nor the business partners creating the false documentation would face private liability. The issuer would claim that its senior management had no specific knowledge of the fraud and therefore lacked scienter, and the business partners that created the false appearance that distorted the published financial

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13. Private actions are particularly important where, as here, defendants' conduct deceives independent public accountants performing an SEC-mandated audit and causes false financial statements to be issued. "[T]he independent auditor assumes a public responsibility" to investors when performing an outside audit and investor confidence depends upon the ability of investors to trust financial statements. *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 n.15 (1984).

statements would simply point to the Eighth Circuit's test and argue that they are beyond the reach of the law.

Without fear of private liability, business partners would have an incentive to provide false documents and records as a service for important customers. For example, a logistics company could hide inventory for customers during audits, then create a false paper trail to ensure that inflated figures make their way into the customers' financial statements. An outside lawyer could forge executive option grants to hide backdating. A testing lab could, for a fee, provide false "proof" that a new invention worked or that a new drug was effective or safe. The logistics company, lawyer, or testing lab that created the false appearance of fact could then claim – as Respondents do here – that they themselves did not make statements to the investing public and therefore are beyond the scope of Section 10(b).

Investors should not be exposed to this threat because an activist court refuses to give plain meaning to the language enacted by Congress.

VI. Respondents' Deceptive Conduct Was a Primary Violation of Section 10(b) and Rules 10b-5(a) and (c).

A. Petitioner Has Alleged Deceptive Conduct and Scienter by Respondents Themselves.

Respondents are parties to this litigation because they engaged in their own fraudulent acts in furtherance of the scheme to defraud Charter investors. Respondents backdated documents to make it appear as if the contracts calling for increases in prices paid for set-top boxes were unrelated to the *quid pro quo* "advertising" agreements they used to funnel Charter's own money back to it as disguised "revenues." J.A. 59a-60a, SAC ¶ 110. Respondents created false documents to give the illusion that the price increases were caused by increased material costs. J.A. 53a, 55a-57a, SAC ¶¶ 93, 100-02. Respondents entered into contracts misrepresenting their

payments to Charter as "advertising," when in fact they were reciprocal payoffs made at five times standard advertising rates. J.A. 61a, SAC ¶ 114. And Respondents knew or recklessly disregarded that the sole purpose of these fraudulent acts was to artificially inflate Charter's published financial statements. J.A. 19a, 55a, SAC ¶¶ 10, 98-99.

Respondents' conduct mirrors that admitted by two Charter executives who were sentenced to over a year in prison for the mail and wire fraud they perpetrated in connection with this scheme. *See United States v. Barford*, SEC Litig. Release No. 19,240 (May 26, 2005). While those executives are no longer part of the investor lawsuit because their claims were settled, it is inconceivable that a court would give them civil immunity. Respondents' deceptive conduct should likewise not be exonerated.

Respondents also engaged in similar forgeries and lies as part of virtually identical sham transactions with another cable provider, Adelphia Communications. *See In re Eidson*, SEC Exchange Act Release No. 54,031 (June 22, 2006); *In re Haislip*, SEC Exchange Act Release No. 54,030 (June 22, 2006); *In re Motorola, Inc.*, SEC Exchange Act Release No. 55,725 (May 8, 2007). As in this case, Respondents backdated their contracts with Adelphia, lied about the reason for price increases, and misrepresented the true "wash" nature of the transactions. *See, e.g., In re Motorola* at ¶ 12. Respondents' repetition of the same deceptive acts confirms that their fraud was knowing and intentional.

B. Investors' Losses Were Causally Connected to the Scheme – Reliance Is Established.

The reliance requirement to maintain a damage suit under § 10(b) is easily satisfied in this case. Reliance, also referred to as transaction causation, provides the requisite causal connection between defendants' fraudulent conduct and plaintiff's injury. *Basic*, 485 U.S. at 243. There is "more than one way to

demonstrate the causal connection." *Id.* It can be established indirectly, and in many cases, presumed. *Id.* (finding that investors who rely on the integrity of an efficient market into which a misrepresentation is disseminated are presumed to have relied indirectly on the misrepresentation).[14] Here, the scheme in which Respondents engaged had the purpose and effect of artificially increasing Charter's revenue and cash flow reflected in Charter's financial statements. Those financial statements caused the price of Charter's stock to be inflated and the purchasers of the stock were accordingly damaged.

Although Respondents did not themselves disseminate the false information to the securities market, "[t]he scheme to defraud would not be complete until the fraudulent information has entered the securities market." *Simpson*, 452 F.3d at 1051.

In complex securities frauds, usually the corporate entity issues the false document in question. But sometimes, as here, the falsity of the document is built upon deceptive acts by secondary actors. Audited financial statements cannot be falsified by merely changing numbers. Inflating audited financial statements requires falsification of supporting documents such as contracts, invoices, shipping orders, and receipts. Those creating the false documents must not be allowed to escape liability by ignoring the role their own deceptive acts played in causing the issuance of the false financial statements that deceived investors.

Imposing private liability when the defendant's own wrongful conduct has been established is not in any way novel or expansive. Businesses have long been responsible for the

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14. The fraud-on-the-market theory applies to claims under Rule 10b-5(a) and (c), as well as direct misrepresentation claims brought under Rule 10b-5(b). *See Simpson*, 452 F.3d at 1051. The securities market for the trading of Charter's stock is alleged to be efficient and well developed. J.A. 28a-29a, SAC ¶ 96; Respt. App. 72-73, AC ¶ 72.

foreseeable consequences of their own improper conduct. *See, e.g., Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 174 (2d Cir.), *cert. denied*, 546 U.S. 935 (2005); *accord Palsgraf v. Long Island R.R. Co.*, 162 N.E. 99 (N.Y. 1928).

Consistent with these principles, the Ninth Circuit has held that in Rule 10b-5(a) and (c) cases, investors "may be presumed to have relied on [a] scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in the market price." *Simpson*, 452 F.3d at 1052. The same analysis was followed in *Parmalat*, where the Southern District of New York explained that:

> The banks made no relevant misrepresentations to those markets, but they knew that the very purpose of certain of their transactions was to allow Parmalat to make such misrepresentations. In these circumstances, both the banks and Parmalat are alleged causes of the losses in question.

376 F. Supp. 2d at 509. Where the deception is "a natural consequence of" or "necessarily resulted from" the defendant's own deceptive acts, "but for" causation is established, "even if a material misstatement by another person creates the nexus between the scheme and the securities market." *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003).

The SEC has agreed that reliance is not dependent upon direct misrepresentations from a particular defendant to investors. In *Simpson,* it took the position that a "prior deceptive act, from which the making of the false statements follows as a natural consequence, can constitute a sufficient step in the causal chain to support a finding of reliance." Amicus Curiae Brief of SEC in *Simpson* at 22.

Recognizing that deceptive acts can indirectly induce reliance is consistent with the language of Section 10(b) and

Rule 10b-5, both of which prohibit persons from indirectly employing deceptive acts. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Moreover, it reflects the fact that investors can be misled by both words and conduct. As the SEC explained, "if two companies together make a false statement about the revenues of one of them, both companies could be primarily liable for securities fraud. If they together achieve the same deception through conduct rather than words, the same result should obtain." Amicus Curiae Brief of SEC in *Simpson* at 19.

Here, Petitioner has alleged that Charter could not have succeeded in publishing the false financial statements that injured investors "but for" the deceptive acts of Respondents. Without the paper trail Respondents fabricated, Charter never would have had a purported basis for the inflated numbers it published to investors, and Charter's auditors never would have acquiesced to the publication of those numbers. J.A. 19a, 53a, SAC ¶¶ 8, 93 (alleging that the transactions were "absolute shams designed solely to give Charter the appearance of increased cash flows" and "increased revenues"); J.A. 19a, SAC ¶ 10 (alleging that Respondents knew that the transactions "were structured to inflate Charter's reported cash flows to investors, and thereby increase Charter's stock price"); J.A. 55a-56a, SAC ¶ 100 (alleging that if the timing and linkage of the set-top box and advertising contracts were honestly disclosed, "the accountants would treat the transactions as a wash").

Indeed, the false documents created by Respondents served no purpose other than to assure that the sham transactions were reflected in Charter's financials. J.A. 53a, SAC ¶ 93. Thus, the false representations Charter made in its financial statements necessarily resulted from and were the natural consequence of Respondents' own deceptive conduct, constituting "a sufficient step in the causal chain to support a finding of reliance." Amicus Curiae Brief of SEC in *Simpson* at 22. *See also Simpson*, 452 F.3d at 1052.

C. Petitioner Should Have Been Granted Leave To Replead.

Because the Court of Appeals applied the wrong legal standard concerning the scope of Section 10(b) and Rule 10b-5, it also held that any amendment by Petitioner would be futile. Pet. App. 11a. Consequently, it affirmed the district court's order denying leave to file the proposed Second Amended Complaint. Where pleading deficiencies appear futile only because the court has applied the wrong legal standard, the plaintiff should be afforded the opportunity to cure pleading defects in an amended complaint. *See United States v. Baxter Int'l, Inc.*, 345 F.3d 866, 903 n.33 (11th Cir. 2003) ("Because we reverse the district court's legal determination as to the viability of the Government's case, the district court's reason for denying leave to amend is no longer valid and that denial is accordingly vacated.").

Leave to amend is especially appropriate here. The amended complaint was the first dismissed by any court, and promptly thereafter Petitioner proffered the Second Amended Complaint curing the identified deficiencies.

CONCLUSION

Congress crafted a statute prohibiting deceptive practices in the purchase or sale of securities and gave authority to the SEC to implement its purposes "in the public interests or for the protection of investors." The SEC has promulgated such rules and Respondents' conduct was clearly in violation thereof. Respondents must not "be free from liability." *Central Bank*, 511 U.S. at 191. For the foregoing reasons, the decision of the Eighth Circuit should be reversed.

Respectfully submitted,

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In the Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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QUESTION PRESENTED

Whether this Court should imply a private cause of action under Section 10(b) of the Securities Exchange Act against vendors whose transactions with a publicly traded company were improperly accounted for by the public company in its financial statements, when the plaintiff—an investor in the public company—did not rely on the transactions or on any statement by the vendors, and the vendors did not use or employ a deceptive device in connection with the purchase or sale of a security.

RULES 14.1(B) AND 29.6 STATEMENT

All parties to the proceeding in the Eighth Circuit are identified in the caption.

The corporate disclosure statements of Motorola, Inc. and Scientific-Atlanta, Inc. are set forth in their briefs in opposition to certiorari.

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STATEMENT

Plaintiff alleges that defendants Motorola, Inc. and Scientific-Atlanta, Inc. (the "Vendors") entered into separate transactions to sell electronic equipment to their customer Charter Communications, Inc. ("Charter"). It further alleges that the Vendors knew or should have known that Charter would account for these transactions improperly in order to inflate its financial results. According to plaintiff's own allegations, Charter's mischaracterization of the Vendors' transactions was an immaterially small part of a long-running fraud by Charter that affected virtually every aspect of its operations and that led Charter, upon disclosure of its misstatements, to lose billions of dollars in stock market value.

The Vendors accounted for the transactions correctly, recording no net gain. They dealt only with Charter, which alone was fully aware of the facts. They had no involvement in the preparation or review of Charter's financial statements, and they made no statements to Charter's investors or accountants and had no duty to do so. Nothing in Charter's public financial statements or other announcements to investors identified the transactions with the Vendors. Plaintiff does not allege that any investor knew of Charter's transactions with the Vendors, let alone relied on them or on any statement by the Vendors when trading Charter securities.

The Eighth Circuit correctly held that plaintiff's allegations amount at most to a claim that the Vendors aided and abetted Charter's fraud—a claim barred by *Central Bank* v. *First Interstate Bank*, 511 U.S. 164 (1994). Plaintiff contends that this suit should proceed because the Vendors engaged in deceptive conduct as part of a "scheme to defraud." That expansive theory of liability would gut *Central Bank*, turning product manufacturers who do business with a customer into "primary violators" potentially liable for unlimited market losses suffered by *the customer's* investors. The result here would be that Motorola and Scientific-Atlanta shareholders

would have to compensate Charter shareholders *for a fraud committed by Charter's own management.*

By labeling a transaction as a "sham," the "scheme" theory would impose upon anyone doing business with a public company legal responsibility for that company's financial reporting. This would leave vendors in the United States and abroad—as well as other commercial partners, lenders, accountants, and lawyers—open to Section 10(b) class action liabilities so disproportionate to any business they might have conducted that irresistible pressure to settle even meritless claims would result.

Plaintiff's "scheme" liability theory would negate *Central Bank's* requirement that a plaintiff establish reliance, an element "critical for recovery under 10b-5," on a defendant-by-defendant basis. 511 U.S. at 180. It also conflicts with the plain language of Section 10(b), which requires that the defendant itself must have used or employed a deceptive device in connection with the purchase or sale of a security. None of those elements is satisfied here. And it contradicts Congress's deliberate policy decision in Section 20(e), 15 U.S.C. § 78t(e), a provision added by the Private Securities Litigation Reform Act (PSLRA) that gave the SEC broad powers over secondary actors while *rejecting* efforts to create a private cause of action for these claims.

The "implied" cause of action plaintiff asks this Court to create is wholly untethered. No guidance as to its contours is found in the express provisions of the securities laws creating secondary liability. And the federal courts would have to engage in a massive round of common law policy-making to determine how reliance, materiality, and loss causation, among other elements, apply to scheme allegations against remote contributors to a fraud—contentious issues that would have to be resolved to flesh out this far-reaching new implied cause of action. Such issues, as the Eighth Circuit held, should be left to Congress.

A. The Statutory And Regulatory Background.

This Court held in *Central Bank* that Section 10(b) and Rule 10b-5 do not create liability for aiding and abetting securities fraud. The Court concluded that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act" and confirmed that plaintiffs "may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." 511 U.S. at 173, 177. A "secondary actor"—such as "a lawyer, accountant, or bank"—that "employs a manipulative device or makes a material misstatement (or omission) *on which a purchaser or seller of securities relies* may be liable as a primary violator under 10b-5," but only if "*all* of the requirements for primary liability under Rule 10b-5 are met." *Id.* at 191 (second emphasis in original).

A year after *Central Bank*, Congress in the PSLRA restored SEC enforcement authority over aiders and abettors, but refused to allow private parties to bring such suits. Section 20(e), 15 U.S.C. § 78t(e), entitled "Prosecution of persons who aid and abet violations," establishes that in an action brought by the SEC "any person that knowingly provides substantial assistance" to a primary violator "shall be deemed to be in violation of [the Exchange Act] to the same extent as the person to whom such assistance is provided."

Congress deliberately left intact *Central Bank's* prohibition of aiding and abetting claims by private plaintiffs. The SEC had argued that Congress should "restore the aiding and abetting liability eliminated in" *Central Bank*. S. Rep. No. 104-98, at 48 (1995). SEC Chairman Arthur Levitt testified that the decision "does away with claims against a whole class of defendants"; he warned that those "whose assistance or acquiescence may have been necessary to the fraud, or who may have been acting behind the scenes, but who did not themselves directly make statements that were relied upon by investors, may escape any liability to private parties"

under *Central Bank*.[1] Congress rejected the SEC's proposal. The Senate Report explained that authorizing "private aiding and abetting liability actions under Section 10(b) would be contrary to [the PSLRA's] goal of reducing meritless securities litigation." S. Rep. No. 104-98, at 19.

Congress revisited the issue again in 2002 when it considered the Sarbanes-Oxley Act. Some legislators argued in favor of amending the 1934 Act to subject aiders and abettors to private suits. *E.g.*, H.R. Rep. No. 107-414, at 54 (2002); 148 Cong. Rec. S6584 (daily ed. July 10, 2002). But although the statute enabled the SEC to distribute administrative recoveries to investors and modified the limitations period governing private lawsuits (15 U.S.C. §§ 1658, 7246), it did *not* extend private civil liability to aiders and abettors.

B. The Vendors' Transactions With Charter.

1. Scientific-Atlanta and Motorola manufacture cable boxes and sell them to cable television providers like Charter, which install them in subscribers' homes. AC ¶¶ 22, 34-35, 75.[2] These "set-top" boxes enable subscribers to access cable television programming and other services. Pet. App. 36a.

Plaintiff alleges that the Vendors are liable under Section 10(b) for engaging in business transactions with Charter, which Charter later accounted for improperly in its financial statements. In these transactions, plaintiff asserts, Charter agreed to pay the Vendors an additional $20 for each set-top

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[1] *Abandonment of the Private Right of Action for Aiding and Abetting Sec. Fraud: Hearing before the Subcomm. on Sec. of the Sen. Comm. on Banking, Hous., & Urb. Aff.*, 103d Cong. 82, 83 (1994).

[2] The Amended Class Action Complaint ("AC") is reproduced in the appendix to Scientific-Atlanta's Brief in Opposition. That complaint was the subject of the district court's ruling on the Vendors' motions to dismiss. As we explain (p. 11, *infra*), the district court denied leave to file the Second Amended Complaint reproduced in the joint appendix.

box purchased during the fourth quarter of 2000 (six percent of the $350 price of a box).[3] The Vendors, in turn, agreed to pay Charter the same amount to support Charter's advertising of digital cable services and equipment. AC ¶¶ 76-77.

Plaintiff alleges that these transactions were proposed by Charter, an important customer of the Vendors, to enable Charter to cover a revenue shortfall. AC ¶¶ 75-80; Pet. Br. 5-6.[4] Plaintiff labels these transactions "kickback arrangements" and a "sham." AC ¶¶ 7, 76-77. But plaintiff does not dispute that the Vendors delivered set-top boxes to Charter, or that the Vendors paid Charter for advertising. Nor does plaintiff allege that no advertising was prepared or aired.

2. As the district court explained, "[i]n 2000, the digital set-top was a relatively new product, and cable operators such as Charter marketed its new features to prospective and existing cable customers." Pet. App. 36a. Advertising agreements were common among cable operators, who wanted new subscribers, and equipment suppliers, whose sales were driven by subscriber growth. See CA Br. of Appellee Scientific-Atlanta 7; AC ¶ 146. More generally, "reciprocal dealing" such as cooperative advertising is recognized as a "useful business practice" for companies "entering into a major contract for products or services." *Teachers' Ret. Sys.* v. *Hunter*, 477 F.3d 162, 178 (4th Cir. 2007).

Plaintiff acknowledges (AC ¶ 80) that there were legitimate methods of accounting for reciprocal marketing transactions. But a host of accounting issues confronted an

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[3] Compl. ¶ 9, *SEC* v. *Scientific-Atlanta, Inc.*, No. 06 Civ. 4823 (S.D.N.Y.), *available at* http://tinyurl.com/3chwzw.

[4] The SEC's cease-and-desist order against Charter likewise states that "*Charter* devised a scheme to get advertising business from its digital set-top box suppliers." *In re Charter Commc'ns, Inc.*, Exchange Act Release No. 50,098, at ¶ 13 (July 27, 2004) (emphasis added), *available at* http://tinyurl.com/2nzsfs.

equipment buyer engaged in such a transaction. In 2000, the Financial Accounting Standards Board had just begun to consider the complex questions involved. The Board saw the vendor's and the customer's accounting obligations as separate matters—with no suggestion that an equipment seller should be held responsible for the buyer's choice of how to account for the transaction. And it had not yet issued specific guidance regarding the treatment each party should use.[5]

3. Charter consulted its auditor, Arthur Andersen, regarding how Charter should account for the transactions with the Vendors. AC ¶ 80. Andersen allegedly advised Charter that it should not recognize the Vendors' payments as advertising revenue because "they appeared integrally related to the cost increases being paid by Charter." *Ibid.* Andersen said Charter could recognize the advertising fees as revenues only if the set-top box payments and advertising fees were at fair market value, unrelated, and negotiated at least a month apart. *Ibid.* The complaint alleges that a Charter executive told Andersen "that Charter would fulfill those conditions," but later "falsely told Arthur Andersen that the advertising and supply contracts" had been "negotiated by two separate departments at Charter a month apart." *Ibid.* The complaint thus asserts that *Charter* misled Andersen regarding the relationship between the transactions and overstated its earnings by immediately recognizing the advertising payments as revenue while capitalizing the added cost of the set-top boxes and depreciating it over time. AC ¶¶ 7, 80. The complaint does not allege that the Vendors were aware that Charter was misleading its auditors.

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[5] See *Accounting for Consideration Given by a Vendor to a Customer*, Emerging Issues Task Force, Issue No. 01-9 (FASB 2001), *available at* http://tinyurl.com/2qb9x2; *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*, Emerging Issues Task Force, Issue No. 02-16 (FASB 2002), *available at* http://tinyurl.com/2mhej8.

Plaintiff does not dispute, moreover, that the Vendors' own accounting for the transactions was proper. The Vendors appropriately booked the sales proceeds as revenue and the advertising payments as an offset to revenue—which had no net impact on their financial statements. See CA Br. of Appellee Scientific-Atlanta 7.

C. Plaintiff Seeks To Hold The Vendors Liable For Charter's Multi-Faceted Scheme To Defraud.

1. Plaintiff filed a putative class action on behalf of Charter's stockholders, making claims under Section 10(b) against Charter, Charter executives, Arthur Andersen, and the Vendors. Plaintiff's Amended Complaint, at issue here, alleges that from November 1999 to July 2002 Charter engaged in a "multi-prong scheme" to inflate revenues and cash flow. AC ¶¶ 8-9. Plaintiff asserts that Charter misrepresented its financial position to investors by falsely doubling its actual growth rate (AC ¶ 4), improperly capitalizing $145 million in labor costs (¶¶ 6, 64e), and improperly deferring $59 million in marketing expenses (¶ 64h), resulting in overstating operating cash flow (¶ 71). A restatement by Charter of its financial reports issued in April 2003 indicated that Charter's operating cash flow had been inflated by $292 million in 2001 and $195 million in 2000, for a total of $487 million. AC ¶ 15.

Plaintiff also alleged that Charter inflated its internal customer growth rate by delaying disconnection for non-paying customers (AC ¶ 5), double-counting and misclassifying subscribers (¶ 53d-e), and making up fictitious subscriber accounts (¶ 55). Plaintiff asserts that Charter's false announcement that it achieved the best customer growth rate in the industry was especially important to analysts and the market. AC ¶¶ 49-51.

Plaintiff states that these practices inflated Charter's stock price to a class-period high of $26.31 per share. AC ¶ 10. Following disclosure of the initiation of a criminal investigation, Charter's stock price fell to $3.50 in July 2002

and $0.76 in October 2002. AC ¶ 16, 147. With 295 million shares outstanding, Charter's loss of market value from its stock price high to its October low exceeded $7 billion. Charter executives ultimately were indicted and convicted for a broad range of misconduct. The SEC also issued a cease-and-desist order against Charter.

In contrast to the massive size and broad scope of Charter's fraud, plaintiff alleges that Charter's improper accounting for *both* Vendors' advertising payments inflated Charter's operating cash flow *for a single quarter by $17 million, i.e., only 3.5% of the total inflation alleged.* AC ¶ 79. Yet plaintiff seeks to hold the Vendors liable for Charter's *entire loss of common stock value.* AC ¶¶ 196-197 (alleging that Vendors acted knowingly or recklessly); see 15 U.S.C. § 78u-4(f)(2)(A) (joint and several liability for knowing violations of the securities laws).

2. Charter's fraudulent accounting practices relating to its own financial statements are at the heart of plaintiff's claims. AC ¶¶ 78-80. But plaintiff does not allege that the Vendors had any control over the financial reporting of Charter, an independent company, or that they "played any role in preparing or disseminating the fraudulent financial statements and press releases through which Charter published its deception to analysts and investors." Pet. App. 4a.

Instead, plaintiff baldly asserts that the Vendors knew or recklessly disregarded Charter's intent to use the transactions to inflate its reported revenue. AC ¶ 196. The only allegation offered to support this assertion is that the set-top box contracts "were back dated to August 2000 on the instructions" of Charter executives to give the "appearance that the set-top box price agreements were negotiated a month before the advertising contracts which were dated in late September." AC ¶ 80. But the complaint alleges that it was *Charter* that used inaccurate characterizations of the transactions to satisfy its accountants. *Ibid.* The complaint does not claim that anything

the Vendors did deceived their counter-party, Charter, or that the Vendors ever provided information to Charter's accountants or any Charter shareholder.

Moreover, although plaintiff alleges that Charter's fraud inflated total earnings (AC ¶ 79), it does not claim that Charter's financial statements disclosed the transactions, or Charter's accounting treatment of them, or any statements or conduct by the Vendors.[6] Plaintiff pleads no facts showing that it or other investors were even aware of the contracts at issue, still less that their decision to purchase or sell Charter's stock was influenced by the existence of these contracts or the immaterial amount of revenue they generated for Charter.

In its brief to this Court plaintiff now asserts (at 6-9) that the Vendors agreed to help Charter deceive its accountants. But the Amended Complaint alleges no particular facts giving rise to a strong inference that the Vendors had such an intent or any facts suggesting that such an agreement existed. See 15 U.S.C. § 78u-4(b)(2). The extra-record material cited by plaintiff shows the opposite. The indictment of Charter's senior executives states that they falsely told their employee who negotiated with the Vendors "that Arthur Andersen had approved the transaction[s]." The executives told him how to document the transactions and he relayed that instruction to the Vendors.[7] Plaintiff pleaded no facts showing that the Vendors knew Charter's executives were deceiving Andersen, let alone that the Vendors intended to help them do so.[8]

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[6] The Form 10-K cited by amici Ohio *et al.* (at 6 n.5) does *not* mention the transactions. See http://tinyurl.com/yrogg6.

[7] *United States* v. *Barford*, No. 4:03CR00434, ¶¶ 22-23 (E.D. Mo. July 24, 2003), *available at* http://tinyurl.com/2pwrwk.

[8] Plaintiff relies (at 11) on SEC proceedings involving a different cable provider, Adelphia. But the SEC in *Adelphia* did not seek to hold the Vendors primarily liable for Adelphia's fraud (as plaintiff does here). Instead, it charged Scientific-Atlanta with aiding and

D. The District Court Dismissed Plaintiff's Complaint Based On *Central Bank*.

The district court granted the Vendors' motions to dismiss. The court held that plaintiff's claims were "for aiding and abetting liability" and thus were "barred by the Supreme Court's decision in *Central Bank*." Pet. App. 39a. The court found that plaintiff's Amended Complaint

- "do[es] not assert that [Vendors] made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by [Vendors]";
- "do[es] not allege that [Vendors] were responsible for" or "involved with the preparation of Charter's allegedly false or misleading financial statements," its "improper internal accounting practices," or the "false or misleading public statements" made by Charter, or that they "even knew of * * * Charter's accounting treatment";
- "do[es] not allege that any of [Charter's false statements] were made, seen, or reviewed by [Vendors]"; and
- "ha[s] not alleged that [Vendors] had any duty to Charter's investors." Pet. App. 41a, 46a.

Instead, plaintiff contended that the Vendors were liable to Charter's investors because "they engaged in a business transaction that Charter purportedly improperly accounted for." Pet. App. 41a. The court found no precedent for that contention and applied the general principle that a plaintiff's "'[r]eliance only on representations made by another cannot itself form the basis of liability'" after *Central Bank*. *Id.* at

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abetting Adelphia and sought a cease-and-desist order against Motorola. These charges were settled without admission or denial of the SEC's allegations. See Compl. ¶¶ 45, 49, *SEC* v. *Scientific-Atlanta, supra, available at* http://tinyurl.com/3chwzw; *In re Motorola, Inc.*, Exchange Act Release No. 55,725 (May 8, 2007), *available at* http://tinyurl.com/2qovcj.

40a. In this Court, plaintiff does not take issue with any of the district court's statements concerning the complaint.

E. The District Court Denied Plaintiff's Motion For Leave To File A Second Amended Complaint.

After dismissal, plaintiff moved for leave to file a Second Amended Complaint (SAC). JA 15a. That complaint, like plaintiff's Amended Complaint, did not allege that the Vendors communicated with Charter's auditors or investors, did not challenge the Vendors' own accounting for the transactions with Charter, and did not allege that no advertising was run (but added allegations that the Vendors paid excessive rates for advertising, SAC ¶ 106).

Plaintiff did more fully allege that the Vendors knew or recklessly disregarded that Charter intended to account for the transactions improperly and to deceive its auditors. The Second Amended Complaint alleged that the Vendors' reckless disregard may be inferred because it is "common knowledge" that equipment purchases are capitalized and that media companies recognize revenue when advertisements are run (SAC ¶¶ 10, 98-100); because Scientific-Atlanta, at Charter's request, sent Charter a letter stating incorrectly that the $20 per box price increase was due to increased manufacturing costs (SAC ¶ 102); and because the Vendors changed the date of the price increase agreements from September to August, as Charter separately requested of each. SAC ¶ 110.

The district court denied leave to amend the complaint. It held that plaintiff's new allegations did nothing to correct the defects identified in the dismissal order, so amendment would be futile. Pet. App. 27a-28a; see *SEC* v. *U.S. Envt'l, Inc.*, 155 F.3d 107, 111 (2d Cir. 1998) (whether a defendant is "a primary violator rather than an aider and abettor turns on the nature of his acts, not on his state of mind").

F. The Court Of Appeals Unanimously Affirmed.

The Eighth Circuit affirmed dismissal of the Amended Complaint. Plaintiff sought to evade *Central Bank*—which involved claims brought under Rule 10b-5*(b)*—by arguing that the Vendors could be held liable as primary violators under Rule 10b-5*(a)* and *(c)*.[9] The Eighth Circuit rejected that tactic, relying on "three governing principles." Pet. App. 8a. First, *Central Bank's* "categorical declaration that a private plaintiff 'may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)' included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b)." Second, "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." Third, "[t]he term 'manipulative' in § 10(b) has the limited contextual meaning ascribed in *Santa Fe*," which defined "manipulation" to mean practices "that are intended to mislead investors by artificially affecting market activity." *Ibid.*; *Santa Fe Indus.* v. *Green*, 430 U.S. 462, 476 (1977).

Applying these principles, the Eighth Circuit held that the Vendors could not be liable for "deceptive" conduct because they "did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." Pet. App. 10a. Plaintiff thus based its complaint against the Vendors on "nothing more than claims, barred by *Central Bank*, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs." *Ibid.* In so holding, the court noted that it was "aware of no case imposing § 10(b) or Rule

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[9] On appeal, plaintiff abandoned its claim that "the Vendors' conduct rose to the level of a misstatement." CA Opening Brief of Plaintiff-Appellant 5 n.3; see AC ¶ 197. Plaintiff's question presented to this Court accordingly assumes that the Vendors made no public misstatements. Pet. i.

10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts." *Ibid.* The court cautioned that imposing liability under these circumstances "would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings," and that such a decision "should be made by Congress." *Ibid.*

Finally, the Eighth Circuit held that the district court did not abuse its discretion in denying plaintiff's motion to amend the complaint. Pet. App. 11a.

INTRODUCTION AND SUMMARY OF ARGUMENT

Prior to *Central Bank* plaintiffs sought to impose liability on defendants whose conduct allegedly facilitated a public company's fraud—but whose conduct was not relied on by investors—by accusing them of "aiding and abetting." After this Court held that Section 10(b) does not create a private cause of action against aiders and abettors, plaintiffs changed the label of their claim to "scheme liability." As every court of appeals to address this question other than the Ninth Circuit has concluded, this subterfuge is barred by *Central Bank*.

Central Bank held that a private damages action for aiding and abetting was precluded for four independent reasons. First, this Court recognized that such an action "would disregard the careful limits on 10b-5 recovery mandated by our earlier cases"—most notably "the reliance requirement." 511 U.S. at 180. Second, aiding and abetting does not fall within "the scope of conduct prohibited by Section 10(b)," as demonstrated by the plain language and structure of the Exchange Act. *Id.* at 172-173. Third, Congress in 1934 "would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action," as shown by the limitations it imposed on express causes of action it did create. Fourth, "[p]olicy considerations" arising from the uniquely burdensome nature of private securities litigation

confirmed the Court's conclusion. *Id.* at 179, 188-190. Each of these holdings applies equally to scheme liability claims.

First, plaintiff's own theory of the case establishes that its "scheme allegations" cannot satisfy the "critical" reliance requirement. *Central Bank*, 511 U.S. at 180. Under *Central Bank* a private Section 10(b) plaintiff must show reliance on each individual defendant's misstatement or omission. *Ibid.* Plaintiff alleges that it relied on *Charter's* false financial statement, but does not claim that the Vendors made any public misstatement, or owed any duty to Charter investors to speak, or that plaintiff was even aware of the Vendors' conduct. Plaintiff's theory that an investor relies on every action that played a role in facilitating a public company's misrepresentation cannot be reconciled with *Central Bank* and would effectively eliminate the reliance requirement.

When it enacted Section 20(e) in response to *Central Bank*, Congress reaffirmed that the implied damages action does not reach secondary actors who make no statements relied on by investors. Congress granted the SEC authority to obtain relief against those who aid and abet false communications but *rejected* the SEC's request that it restore private aiding and abetting liability for defendants who "did not themselves directly make statements that were relied upon by investors." See pp. 3-4, *supra*. Section 20(e) defines aiding and abetting as "provid[ing] substantial assistance" to a primary violator—precisely what the Vendors are accused of here.

Second, the language and structure of the 1934 Act confirm that Congress did not intend to turn product suppliers, who do not speak to investors, into watchdogs for the accounting practices of public companies. The conduct alleged does not satisfy the plain language of Section 10(b) because the Vendors did not "use or employ" a "deceptive device" "in connection with" the purchase or sale of a security. Charter, not the Vendors, "used or employed" deception in communi-

cating with investors. And because there was no nexus between the Vendors' alleged conduct and plaintiff's trading in Charter securities, that conduct was not "in connection with" securities trading.

Third, the Court's interpretation of private Section 10(b) actions has been guided by the express causes of action in the securities laws. Those express private actions preclude scheme liability, as does Congress's explicit provision for liability for secondary actors, which is limited to "control persons." Extending the implied private right of action to cover secondary actors would not only disregard this express statutory language, but also would necessitate rewriting the requirements of reliance, materiality, and loss causation, forcing courts to engage in extensive lawmaking.

Finally, policy considerations regarded by this Court as important in prior Section 10(b) decisions require rejection of scheme liability. Extending liability to secondary actors with a remote connection to the fraud—through a nebulous "purpose and effect" test that makes it impossible to obtain dismissal—would invite abuse. Pressure on secondary actors to settle would be magnified by rules that make knowing violators responsible for the entire fraud. Investors would be harmed as suppliers, lenders, and professionals declined service or increased prices to compensate for increased risk.

Implied private suits are unnecessary to deter secondary actors from participating in a public company's fraud or to compensate investors. Section 20(e) empowers the SEC to punish aiders and abettors with civil penalties and to use disgorgement to compensate investors. Criminal prosecution by the Department of Justice and state officials further deters involvement in fraud. Affirmance here will sustain Congress's policy judgment that private plaintiffs should not be allowed to impose aiding and abetting liability, a judgment they may not evade simply by changing the label of their claim to "scheme liability."

ARGUMENT

I. LIABILITY IS PRECLUDED IN THIS CASE BY *CENTRAL BANK'S* RELIANCE REQUIREMENT, THE LANGUAGE OF EXCHANGE ACT SECTIONS 10(b) AND 20(e), AND ESTABLISHED LIMITS ON JUDICIALLY IMPLIED CAUSES OF ACTION.

Central Bank drew a bright line between "giving aid to a person who commits" a deceptive practice, which is not actionable in a private damages suit under Section 10(b), and committing deceptive practices in connection with the purchase or sale of a security, which does fall within Section 10(b)'s proscription provided *all* the elements of liability are met. 511 U.S. at 177-178. In dismissing plaintiff's complaint the Eighth Circuit properly held that the Vendors could not be liable for using or employing a "deceptive act" in connection with the purchase or sale of a security because they "did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." Pet. App. 10a.

Plaintiff acknowledges that the Vendors "made no public statements concerning [the] transactions" at issue. Pet. Br. i; see Pl. C.A. Br. 5 n.3 (abandoning claim that "Vendors' conduct rose to the level of a misstatement"); Pet. App. 10a. Plaintiff has not alleged that Vendors owed a duty of disclosure to Charter shareholders, which would arise only from a "specific relationship" of "trust and confidence" absent here. Pet. App. 41a; *Central Bank*, 511 U.S. at 180; *Chiarella* v. *United States*, 445 U.S. 222, 233 (1980). And plaintiff has not alleged that the Vendors engaged in manipulation—a "term of art" that refers to illegal trading practices such as "wash sales, matched orders, or rigged prices." *Santa Fe*, 430 U.S. at 476-477. Accordingly, the Eighth Circuit was correct in holding that the test for primary liability in *Central Bank* is

not satisfied. The Vendors were at most aiders and abettors of Charter's fraud.

Plaintiff nevertheless asserts that the Vendors are liable because they engaged in transactions that *Charter* subsequently accounted for improperly after misleading its auditors. Plaintiff alleges that the Vendors independently provided documents *to Charter alone, at Charter's request*, misstating the reason for the set-top box price increase and the date of that increase. According to plaintiff, because these documents were used by Charter to advance its far-reaching scheme to inflate its financial results, the Vendors should be liable for all of Charter investors' losses, even though the Vendors accounted for the transactions properly and Charter's investors did not rely on—indeed were unaware of—the transactions and documents at issue.

Central Bank bars this claim. It makes clear that a private damages action under Section 10(b) is valid only where "*all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191. Here, *none* of the requirements for primary liability is satisfied.

A. Scheme Liability Claims Cannot Satisfy Section 10(b)'s Reliance Requirement.

We begin with the question of reliance because that issue was addressed in *Central Bank* in terms that apply directly here. This Court there held that the reliance requirement precludes aiding and abetting liability in private actions. "Were we to allow the aiding and abetting action proposed in this case," the Court stated, "the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions. * * * Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases." 511 U.S. at 180. The absence of that "critical element for recovery" barred aiding and abetting claims. *Ibid.* See *id.* at 191 (defendant may be liable as a primary violator only

when it "makes a material misstatement or omission on which a purchaser or seller of securities relies").

Central Bank thus recognized that a plaintiff "must show reliance on *the defendant's* misstatement or omission to recover under 10b-5." 511 U.S. at 180 (emphasis added); see *Wright* v. *Ernst & Young*, 152 F.3d 169, 175 (2d Cir. 1998) ("'reliance only on representations made by others cannot itself form the basis of liability'"). As then-SEC Chairman Levitt explained, under *Central Bank* a plaintiff "must show, *defendant by defendant*, that the plaintiff reasonably relied on the defendant's misstatement or omission." *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud, supra* p. 4 n.1, 103d Cong. 51 (emphasis added). The direct clash between this Court's application of the reliance requirement in *Central Bank* and plaintiff's scheme theory provides an indisputable basis for dismissal.

Here, plaintiff concedes that the Vendors did not communicate with Charter investors and does not allege that investors knew of the transactions at issue, the documents increasing set-top box prices, or any statement made to Charter of the reason for the price increase. Plaintiff's attempt to plead reliance rests on allegations that *Charter* issued false financial statements that reflected commercial transactions that Charter procured to carry out its fraud. See Pet. Br. 39 (arguing that reliance is satisfied by "a prior deceptive act, from which the making of the false statements [to investors] follows as a natural consequence"; the Vendors' conduct "indirectly induce[d] reliance").[10]

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[10] There is a presumption of reliance for "misleading statement[s] by the corporation" issuing a security, based upon the securities laws' "philosophy of full disclosure" by public corporations. *Basic Inc.* v. *Levinson*, 485 U.S. 224, 226, 230, 235 n.12 (1988). But that presumption applies only to statements directed to the market. Here, plaintiff has conceded that the Vendors made *no* such public statement. Moreover, while it accords with "common sense and

The fiction that plaintiffs who rely on a misstatement also rely on the actions of every party alleged to have played some behind-the-scenes role leading up to that misstatement cannot be reconciled with *Central Bank's* holding that plaintiffs must prove they relied on the actions of each individual defendant. Indeed, that fiction would have led to a different result on the facts of *Central Bank* itself. And it would effectively eliminate reliance (or "transaction causation") as a limit on private securities fraud liability, changing it from an inquiry designed to limit liability to those whose actions have caused investors to trade to an open-ended inquiry into whose actions made it possible for a public company to make a misstatement—the very definition of aiding and abetting.

Congress's response to *Central Bank* confirms that Section 10(b) does not authorize private suits against secondary actors who make no statements relied on by investors. The SEC urged Congress to "restore" the aiding and abetting "liability [*Central Bank* had] eliminated," including private liability for damages. S. Rep. No. 104-98, at 48. As we have noted, Chairman Levitt stated that otherwise those who acted "behind the scenes" or "whose assistance or acquiescence may have been necessary to the fraud," but who "did not themselves directly make statements that were relied upon by investors, may escape any liability to private parties." *Supra* p. 4 n.1. Congress rejected the SEC's argument. "[P]rivate aiding and abetting liability actions," the Senate Report explained, "would be contrary to [the PSLRA's] goal of reducing meritless securities litigation." S. Rep. No. 104-98, at 19.

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probability" to presume that an issuer's false denial of merger plans in public statements will affect the price of its stock (*id.* at 246), there is no warrant to presume that conduct of other commercial entities will do so, as *Central Bank* recognizes—even less so conduct that is unknown to investors, engaged in by commercial parties who have no duty of disclosure to those investors.

In enacting Section 20(e) as part of the PSLRA, Congress chose not to write reliance out of private Rule 10b-5 litigation. Refusing to "restore private actions against aiders and abettors," Congress instead granted "the SEC express authority to bring actions seeking injunctive relief or money damages against persons who knowingly aid and abet primary violators of the securities laws"—enforcement actions in which proof of reliance is not required. 4 BROMBERG & LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 7:307, at 7-503 (2d ed. 2007). This compromise legislation was designed to *"remov[e] the plaintiffs' class action bar from the equation"* while protecting investors by granting the SEC broad authority over secondary actors. *Id.* § 7:308, at 7-506 (emphasis added). In the Sarbanes-Oxley Act, Congress again rejected entreaties to restore private aiding and abetting liability. See *supra*, p. 4.

The language Congress used in Section 20(e) is telling. Entitled "[p]rosecution of persons who aid and abet violations," the amendment provides that "any person that knowingly *provides substantial assistance* to another person in violation of a provision of this title * * * shall *be deemed to be in violation of such provision* to the same extent as the person to whom such assistance is provided." 15 U.S.C. § 78t(e) (emphasis added). Congress thus equated "persons who aid and abet violations" of Section 10(b) with those who "provid[e] substantial assistance" to a violator. See *INS* v. *National Ctr. for Immigrants' Rights*, 502 U.S. 183, 189 (1991) (reading text and title of provision together). And in finding it necessary to *deem* substantial assistance of a violation of Section 10(b) to be within the SEC's enforcement powers, Congress reaffirmed that the statute would not otherwise reach those who provide substantial assistance. The connection between *Central Bank* and the language of Section 20(e) is clear: *Central Bank* held that there can be no "showing that the plaintiff relied upon [an] aider and abettor's statements or actions" (511 U.S. at 180), and Congress

responded by permitting actions against "persons who aid and abet violations" to be brought only by the SEC, which is not subject to the reliance requirement.

Plaintiff's scheme theory is inconsistent with the plain language of Section 20(e) and frustrates Congress's considered decision to reject private aiding and abetting liability. Congress provided an express SEC-enforced remedy against those who substantially assist a public company's fraud, and "when Congress enacts a specific remedy when no remedy was previously recognized," as occurred in 1995, "the remedy provided is generally regarded as exclusive." *Hinck* v. *United States*, 127 S. Ct. 2011, 2015 (2007); see *EC Term of Years Trust* v. *United States*, 127 S. Ct. 1763, 1767 (2007) ("'a precisely drawn, detailed statute pre-empts more general remedies'"—here, *implied* private remedies); *Alexander* v. *Sandoval*, 532 U.S. 275, 290 (2001) ("[t]he express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others").

B. Plaintiff's Claim Does Not Fall Within The Scope Of Conduct Prohibited By The Plain Language Of Section 10(b).

Given the absence of any communication between the Vendors and Charter investors and the complete lack of reliance, it is hardly surprising that plaintiff's scheme claim fails to satisfy the statutory language Congress prescribed to place limits on 10(b) liability. *Central Bank* confirmed that, in "cases considering the scope of conduct prohibited by § 10(b) in private suits," this Court has "emphasized adherence to the statutory language." *Central Bank*, 511 U.S. at 173. Here as in *Central Bank* the text of the statute establishes that plaintiff has no implied private right of action.

1. The Vendors did not "use or employ" a "deceptive device" "in connection with" a securities transaction. Plaintiff focuses myopically (at 20-22) on the phrase "deceptive device or contrivance." Its principal argument targets a straw

man: that our position and the court of appeals' holding rest on the principle that spoken or written words are essential to prove a § 10(b) violation. In fact, we do not dispute that communicative conduct—for example, presenting potential investors with a misleading display that makes nonfunctional factory equipment appear operational—*may* amount to a "deceptive device or contrivance."[11]

The particular conduct alleged here—false statements in contracts between the Vendors and Charter—does not qualify as a "deceptive device." See BLACK'S LAW DICTIONARY 528 (3d ed. 1933) ("deceit" is an artifice used "to deceive and trick another, who is ignorant of the true facts"). The alleged scheme to mislead was Charter's, not the Vendors'. The Vendors dealt *only* with Charter, which was not ignorant of the true facts and was not deceived in any way.

The phrase "deceptive device or contrivance," moreover, does not appear in isolation. Section 10(b) does not reach every deceptive device; it prohibits only the use or employment of such devices in connection with the purchase or sale of a security. The Court recently remarked on the importance of statutory terms that, viewed in "context," "limit the reach" of potentially broader phrases. *Dolan* v. *United States Postal Serv.*, 546 U.S. 481, 486-487 (2006); see *Gustafson* v. *Alloyd Co.*, 513 U.S. 561, 575 (1995) ("a word is known by the company it keeps"—a rule that "we rely upon to avoid * * * giving 'unintended breadth to the Acts of Congress'").

"Use" and "employ" are active verbs. "Use" signifies "active employment." *Jones* v. *United States*, 529 U.S. 848,

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[11] References to "misrepresentations," "omissions," and "conduct" in the PSLRA and SLUSA show only that Section 10(b) liability may rest on manipulative conduct or conduct that amounts to an actionable misrepresentation. Contrary to plaintiff's argument (at 21-22), they do not suggest that providing assistance to a primary violator gives rise to a private damages action.

855 (2000); see *Bailey* v. *United States*, 516 U.S. 137, 145 (1995) (the "'ordinary or natural' meaning" of "use" is "'to convert to one's service'" or "'to avail oneself of'"); WEBSTER'S NEW INT'L DICTIONARY 839 (2d ed. 1934) ("employ" is to "make use of, as an instrument, means, or material"). The phrase "use or employ * * * any * * * deceptive device" thus confirms that a party's liability may *not* rest on a deceptive device used or employed by another. Rather, a defendant is liable only if it engaged in the prohibited conduct of using or employing a device to deceive investors.

In ordinary parlance, it cannot be said that A "uses" or "employs" a deceptive device in dealings with B when B is aware of the true facts—as was the case with the transactions here. And if A agrees to assist B in deceiving a third person, C, A still is not using or employing a deceptive device. A's actions can only be understood as facilitating the deception practiced by B—facilitative conduct that *Central Bank* held is not actionable under Section 10(b). See 511 U.S. at 177 (Section 10(b) does not proscribe "giving aid to a person who commits a manipulative or deceptive act").

Section 10(b) also requires that each defendant use or employ a deceptive device "in connection with the purchase or sale" of a security. To find that requirement satisfied here would strip it of any practical meaning and improperly extend the scope of Section 10(b) to "cover the corporate universe." *Santa Fe*, 430 U.S. at 480; see *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 733-734 & n.5 (1975) (the "in connection with" requirement is "badly strained" when construed to cover "the world at large").

In *United States* v. *O'Hagan*, 521 U.S. 642, 652-655 (1997), the Court held that a lawyer violated Section 10(b) by trading securities based on information misappropriated from his client in violation of a duty of trust, deceiving the client by nondisclosure. In holding the "in connection with" requirement satisfied, the Court stressed that the "securities

transaction and the breach of duty * * * coincide": the defendant "use[d] the [misappropriated] information to purchase or sell securities." *Id.* at 656.

In contrast to that inseverable connection, the Court gave an example of a deception that is too "detached from a subsequent securities transaction" to satisfy Section 10(b): when "'a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities.'" 521 U.S. at 656-657. In those circumstances the "in connection with" requirement "would not be met." *Id.* at 657. The dissenting Justices in *O'Hagan* would have required a closer connection still between the deception and the purchase or sale of a security. 521 U.S. at 679 (Scalia, J., dissenting); *id.* at 685-686 (Thomas, J., and Rehnquist, C.J., dissenting).

Similarly, in *SEC* v. *Zandford*, 535 U.S. 813 (2002), the defendant broker sold a customer's securities in order to convert the proceeds. These sales and fraudulent conversions were not "independent events." *Id.* at 820. Even though there was no "misrepresentation about the value of a particular security," the "in connection with" requirement was satisfied by a failure to disclose where there was a duty to speak that "coincided with the [securities] sales themselves." *Ibid.* The requirement would not, however, be satisfied if, "after a lawful transaction had been consummated, a broker decided to steal the proceeds," or "a thief simply invested the proceeds of a routine conversion in the stock market." *Ibid.* Accord *Merrill Lynch* v. *Dabit*, 547 U.S. 71, 85 (2006) (insisting that "the fraud alleged 'coincide' with a securities transaction—whether by the plaintiff or by someone else").

In each of these cases the trading was integral to the fraud or there was a direct nexus between the deceptive conduct and the trading of securities. The defendant traded on misappropriated information, traded to convert the proceeds to his own use, or disseminated misstatements to investors. But the

standards adopted in these cases make clear that the "in connection with" requirement is *not* met when a defendant's conduct is as remote from securities trading as that alleged here. See *Zoelsch* v. *Arthur Andersen*, 824 F.2d 27, 34-35 (D.C. Cir. 1987) (Bork, J.) (accountant's misleading statements to a foreign affiliate, which used them in preparing a prospectus distributed to investors, were not made "in connection with" securities purchases; the accountant's answers to private inquiries did not "establis[h] any particular relationship with the investing public," and knowledge that its statements "might be used in some later prospectus" was not enough); *Chemical Bank* v. *Arthur Andersen*, 726 F.2d 930, 943-945 (2d Cir. 1984) (Friendly, J.) ("in connection with" not satisfied by accountant's misrepresentations regarding public company that led banks to make loans, even though the banks also obtained stock as security; "'but-for' causation is not enough"); *Rand* v. *Anaconda-Ericsson, Inc.*, 794 F.2d 843, 847-848 (2d Cir. 1986) (Winter, J.) (extending Section 10(b) to conduct "remote from transactions in the market for capital," such as misrepresentations about "a competitor's goods," would produce "a virtually limitless legal theory"); *Taylor* v. *First Union Corp.*, 857 F.2d 240, 245-246 (4th Cir. 1988) (Wilkinson, J.) (rejecting claim where fraud was "tangentially and incidentally related to the sale of plaintiff's stock").

By juxtaposing the active verbs "use or employ" with the "in connection with" requirement, Congress made clear that the defendant's active employment of a deceptive device must be connected to the plaintiff's securities transactions. There is no such coincidence between the Vendors' alleged deceptive acts and plaintiff's trading in Charter securities. Once the Vendors independently supplied Charter with the documents plaintiff says were deceptive, their alleged misconduct was "complete." *O'Hagan*, 521 U.S. at 656. The Vendors accounted for the transactions properly, had no control over Charter's accounting for them, had no contact with

Charter's auditors, made no statements to Charter's investors, and owed those investors no duty of disclosure.

The Vendors' alleged conduct is thus as "detached" from the alleged fraud as any of the examples of inadequate nexus this Court gave in *O'Hagan* and *Zandford*. Plaintiff's bare assertion that the Vendors should have known that their transactions would facilitate Charter's ultimate false statements does not cure this defect. The Court in *O'Hagan* and *Zandford* did not suggest that the outcome of its examples of fraud not "in connection with" buying or selling securities would have been different if there were proof that the defendant planned to use the proceeds to buy stock.

Plaintiff's scheme theory departs radically from settled law. On that theory *any* transaction ultimately taken into account in a public company's financial statements would satisfy the "in connection with" requirement—however many stages and whatever independent conduct intervened. To stretch this statutory requirement to reach vendor conduct so far removed from investors' decisions to trade securities would by "judicial extension" enlarge Section 10(b) "to 'cover the corporate universe,'" contrary to Congress's intent. *Santa Fe*, 430 U.S. 480; see *Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud"); see also *Conrail* v. *Gottshall*, 512 U.S. 532, 552-553 (1994) ("Conditioning liability on foreseeability" is "hardly a condition at all").

2. Section 10(b)'s jurisdictional language does not extend liability to secondary actors. Plaintiff makes much (at 19-20) of Section 10(b)'s language providing that it is unlawful, "directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails," to use or employ a deceptive device in connection with a securities transaction. But this Court in *Central Bank* squarely rejected the contention that the term "indirectly" broadens the scope

of section 10(b) liability. 511 U.S. at 176. "[T]here is no support for the proposition that Congress intended the 'directly or indirectly' language to encompass secondary liability." Daniel Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 94 n.83 (1981). Rather, "[t]he statutory scheme suggests the opposite." *Ibid.* Dean Fischel, whose views this Court relied on in *Central Bank*, explained that the "directly or indirectly" language is part of Section 10(b)'s jurisdictional clause and "allows liability to be imposed upon a defendant" who "does not himself use the jurisdictional means (*i.e.*, mail a letter in interstate commerce)." *Ibid.*; see also 5B ARNOLD JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 8:2, at 8-15 & n.90 (2007) (a defendant "need not personally make use of the mails or interstate commerce; because [of] 10b-5's words 'directly or indirectly,' * * * any use by one defendant is sufficient to implicate others" in "the use of jurisdictional means") (citing cases).

At the time the Exchange Act was passed there was considerable debate regarding the scope of Commerce Clause regulation of securities activity and "prevailing skepticism about the constitutional warrant for federal regulation of stock exchanges." John Hanna, *The Securities Exchange Act of 1934*, 23 CAL. L. REV. 1, 23 (1934). Congress's use of the term "indirectly" sought to reach those who would evade federal regulation by using other persons to perform jurisdictional acts. That intent is confirmed by the placement of the phrase "directly or indirectly" immediately before the clause "by use of any means or instrumentality of interstate commerce." See also 15 U.S.C. §§ 77e(a)-(c), 77q, 78e, 78i(a), 78dd(a). In contrast, the phrase that plaintiff says "indirectly" relates to—"use or employ" a "deceptive device"—occurs two subparts and some 80 words later. See *Jama* v. *Immigration & Customs*, 543 U.S. 335, 343 (2005) (a "'limiting clause or phrase'" modifies "'only'" the phrase it "'immediately follows'").

Where Congress meant the phrase "directly or indirectly" to modify the language prohibiting certain conduct it knew how to say so by placing that phrase immediately before the prohibition. *E.g.*, 15 U.S.C. §§ 78d(a), 78g(c), 78h, 78i(c), 78p(c), 78t(a). For example, the term "directly or indirectly" appears *twice* in Section 9(a)(5)—once before the jurisdictional clause, as in Section 10(b), and again before the prohibition (direct or indirect receipt of consideration to induce purchase of a security at a manipulated price); 15 U.S.C. § 78i(a)(5); see also S. 2693, 73d Cong., § 8(a)(6) (1934).

Because the term "indirectly" modifies only Section 10(b)'s jurisdictional phrase, it cannot be construed to extend liability to secondary actors who engage in a transaction later used by another to defraud investors. That broad reading of "indirectly" would in any event be impermissible, because it would effectively eliminate the "in connection with" and reliance requirements as meaningful constraints on liability. See *United Sav. Ass'n* v. *Timbers of Inwood Forest*, 484 U.S. 365, 375 (1988) (one provision may not be construed to make "a practical nullity" of another).

C. The Structure Of The Securities Laws Confirms That Congress Would Not Have Permitted Private Damages Actions Under Section 10(b) Based On Scheme Liability Claims.

Even if the terms Congress used were not so clear and the incompatibility between scheme liability and the reliance requirement not so obvious, the same result would be required by the structure of the federal securities laws. In interpreting the scope of the *implied* private right of action under Section 10(b), this Court has paid particular attention to both subsequent legislative enactments and the *express* causes of action created in the 1933 and 1934 Acts. See *Central Bank*, 511 U.S. at 178 ("we use the express causes of action in the securities Acts as the primary model for the § 10(b) action").

1. The express private causes of action demonstrate that damages liability does not extend to remote secondary actors. The extraordinarily broad scope of plaintiff's scheme liability theory is starkly inconsistent with Congress's approach in crafting the express causes of action. The scope of each express cause of action is strictly cabined through precise description of the class of persons subject to liability, narrow delineation of the conduct that can give rise to private liability, or both. See *Central Bank*, 511 U.S. at 179. Thus, Section 11(a) of the 1933 Act imposes liability for false registration statements on a limited group of persons who communicate with investors as directors or underwriters, who sign the registration statement, or who express expert opinions in it. 15 U.S.C. § 77k(a). Section 9(e) of the 1934 Act confers a narrow right of action on persons who establish the price impact of carefully defined manipulative practices in stock market trading. *Id.* § 78i(e).

Two express private causes of action are particularly instructive. Section 12 of the 1933 Act reaches any person who "offers or sells a security" by means of a false or misleading prospectus. 15 U.S.C. § 77*l*. This Court in *Pinter* v. *Dahl*, 486 U.S. 622, 642 (1988), recognized that this language imposed liability on "the owner who passed title, or other interest in the security, to the buyer for value." Relying on the statute's definition of the term "offer" to include "solicitation of an offer to buy" (15 U.S.C. § 77b(a)(3)), the Court concluded that Section 12 also reached one "who successfully solicits the purchase." 486 U.S. at 647. But the Court rejected plaintiff's contention, "grounded in tort doctrine," that liability reached anyone "'whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place.'" *Id.* at 649. The Court found no basis for that sweeping approach in the statute and "no congressional intent to incorporate tort law doctrines." *Id.* at 652. The Court also rejected the SEC's argument that those "who 'participate in soliciting the purchase'" should be liable. *Id.* at 651 n.27.

Section 18 of the 1934 Act likewise creates a narrowly drawn claim against any person "who shall make or cause to be made" a false or misleading statement in an SEC filing. To trigger this liability a plaintiff must individually prove that he bought or sold a security "in reliance upon such statement." 15 U.S.C. § 78r(a). The fraud on the market presumption does not apply. *Heit* v. *Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968); *In re Adelphia Commc'ns Corp. Sec. Litig.*, 2005 U.S. Dist. Lexis 43300, at *31 (S.D.N.Y. 2005).

The *Central Bank* bright line rule, applied by the Eighth Circuit here, is consistent with the approach Congress took in creating these express causes of action—closely cabining the scope of liability. By contrast, plaintiff's theory, in which a "purpose and effect" to further an issuer's fraudulent scheme is enough to expose any secondary actor to potentially massive liability, is the same as the "participation" standard rejected in *Pinter*. It would impose liability on an open-ended class of persons for a nebulous category of conduct, an approach Congress did not take *anywhere* in the securities laws. This Court has repeatedly declined to expand implied rights of action under the securities laws beyond the scope of the express remedies. *Central Bank*, 511 U.S. at 180 (it would be "anomalous to impute to Congress an intention in effect to expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action"); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 200-201 (1976); *Lampf, Pleva* v. *Gilbertson*, 501 U.S. 350, 359-360 (1991). It should decline to do so again here.

2. Congress did not mean to reach secondary actors who are not "control persons." Plaintiff's broad "scheme liability" approach also conflicts with Congress's carefully limited criteria for imposing secondary liability. Congress expressly dealt with secondary actors in both the 1933 and 1934 Acts and made them liable only to the extent that they "control" the issuer—control that the Vendors lacked over Charter. See 15 U.S.C. §§ 77b(a)(11), 78t(a); 17 C.F.R.

§ 240.12b-2 ("control" means possession of "power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise"). When Congress in Section 20(e) expanded secondary liability to cover aiders and abettors, it did so only for SEC actions, leaving the control person provisions to govern private actions.

"Control person" provisions are the touchstone for analyzing the scope of liability under Section 10(b) for persons other than those who "use or employ" misstatements "in connection with" the purchase or sale of a security. See *In re Miller*, 276 F.3d 424, 429 (8th Cir. 2002) (control person provisions "exten[d] liability well beyond traditional doctrines" of agency and respondeat superior). Courts have routinely applied these provisions to impose liability on corporations and individuals. *E.g.*, *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 70, 74-76 (2d Cir. 2001). Extending liability beyond the line Congress carefully drew would be inconsistent with its intent, as this Court recognized in *Central Bank*. See 511 U.S. at 184 ("[t]he fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere"); Fischel, *supra*, 69 CAL. L. REV. at 94 n.83 (broader theories of secondary liability would make control person provisions "surplusage").

D. Extensive Judicial Lawmaking Would Be Needed To Address The Clear Incompatibility Between Scheme Liability And Existing Standards For Section 10(b) Damages Actions.

Plaintiff's claim—and private scheme liability in general—do not "fit" existing Section 10(b) requirements of materiality or loss causation any more than they fit reliance standards. Each of these elements would have to be recast before it could be satisfied in "scheme" suits, necessitating the sort of judicial lawmaking this Court eschews.

Materiality. A Section 10(b) plaintiff must prove that the defendant's misstatement concerned facts material to the plaintiff's decision to purchase or sell securities. *TSC Indus.* v. *Northway, Inc.*, 426 U.S. 438 (1976). The materiality test thus looks to the importance of the alleged false information communicated to the plaintiff or the market. In the scheme liability context, where the alleged misstatement is not communicated to either, there is a mismatch between the alleged wrongdoing and materiality analysis. Indeed, the only allegations of materiality here relate to *Charter's* misstatements (*e.g.*, AC ¶ 8, SAC ¶ 127), and plaintiff did not allege that the Vendors' alleged deceptive conduct was material.

The absence of such an allegation is understandable. In contrast to the $487 million inflation of cash flow for 2000 and 2001 alleged by plaintiff to have resulted from Charter's fraud (AC ¶ 15) and to Charter's $7 billion loss of market value upon revelation of its fraud, plaintiff claims that Charter's improper accounting for the transactions with the Vendors inflated operating cash flow for one quarter by only $17 million, *i.e.*, 3.5% of the total inflation alleged. *Supra*, p. 8. Plaintiff does not allege that the Vendors acted in concert, so the alleged impact of each of their individual transactions was considerably less. As a "rule of thumb" a deviation of less than 5% "is unlikely to be material." *SEC Staff Accounting Bulletin No. 99—Materiality* 2 n.2 (Aug. 12, 1999); see *Higginbotham* v. *Baxter Int'l*, 2007 WL 2142298, at *5 & n. (7th Cir. July 27, 2007) (Easterbrook, J.).

If the Court recognized scheme liability, it would have to determine how materiality would be assessed with respect to such claims. Would the Court adopt a new standard under which the secondary actor's liability turns upon the materiality of the issuer's statement, no matter how small the scheme liability defendant's contribution to the issuer's misstatement? Or would liability turn on the materiality of the scheme liability defendant's misstatements? That too would require creation of a new standard—breaking the link be-

tween the materiality assessment and the statement communicated to investors. Under this approach, materiality would turn on a statement *not* communicated to investors. And a defendant in the position of the Vendors would not know whether its statement was material in light of the issuer's financial situation. Either way, materiality law would have to be revised totally if scheme claims were to be viable.

Loss causation. A private plaintiff must also plead that "the act or omission of the defendant" "caused the plaintiff's economic loss." 15 U.S.C. § 78u-4(b)(4); *Dura Pharms.* v. *Broudo*, 544 U.S. 336, 346 (2005). In *Dura*, this Court held the complaint insufficient because it did not allege "what the causal connection might be between [plaintiff's] loss and the misrepresentation[s]." *Id.* at 347. Plaintiff here could not establish any such causal connection. To do so it would have to demonstrate the effect of each Vendor's alleged conduct on the market—separate from the effect of myriad false statements in Charter's financial reports. See *Lentell* v. *Merrill Lynch & Co.*, 396 F.3d 161, 174-177 (2d Cir. 2005). Because Charter's financial statements falsely described a multitude of facts of far greater magnitude, and did not separately inform the market of the Vendor transactions, there is no method for segregating the impact of Charter's accounting for the Vendor transactions from "the tangle of factors affecting price." *Dura*, 544 U.S. at 343. If "scheme" liability were created, the judiciary would also have to create entirely new standards for loss causation.

Reliance. As we have discussed, existing reliance requirements do not fit scheme liability because the defendant's statements are not communicated to the market or to individual investors. To the extent that incompatibility does not preclude scheme liability claims, it would require courts to invent new reliance standards to apply to such claims.

The content of all of these new standards would be highly controversial because class action claimants could impose

enormous damages against suppliers of goods, services, or financing that had only minor roles in an alleged scheme. Under Exchange Act § 21D(f)(2) a defendant found to have "knowingly committed a violation of the securities laws" may potentially be held jointly and severally liable for the entire loss resulting from the fraud. Secondary actors could face billions of dollars in damages if they were found liable on a scheme theory. See p. 8, *supra*; *In re Fannie Mae Sec. Litig.*, MDL No. 1668 (D.D.C. Aug. 12, 2006), 2d Am. Consol. Class Action Compl. (seeking to hold bank jointly and severally liable for alleged loss of $12 billion resulting from Fannie Mae's false financial statement, where bank allegedly participated in only two transactions that Fannie Mae misused to shift $107 million in revenue to future quarters).[12]

Creating new standards would require extensive judicial lawmaking. If the Court today confronted the question whether to imply a private cause of action under Section 10(b), it would decline to do so. See *Alexander*, 532 U.S. at 289 (statutes like Section 10(b) that "focus on the person regulated rather than the individuals protected" imply no intent to create a private right of action); *Transamerica Mortgage* v. *Lewis*, 444 U.S. 11, 19-20 (1979) (declining to imply private right of action to enforce the antifraud provision of

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[12] Plaintiff contends that the PSLRA's proportionate liability provision shows Congress contemplated broad secondary liability. Pet. Br. 22; 15 U.S.C. § 78u-4(f). But Congress's goal in that provision was to address "the chilling effect of unlimited [damages] exposure" on defendants subject to primary liability, such as auditors, underwriters, and directors. H.R. Conf. Rep. No. 104-369, at 38 (1995). Having refused to overturn *Central Bank*, Congress had no reason to contemplate secondary liability in private actions. The scheme liability theory had not yet been invented. Under plaintiff's new "purpose and effect" standard a secondary actor found liable would always have the "knowledge" needed to trigger joint and several liability, guaranteeing grossly disproportionate damages in virtually all cases.

the Investment Advisers Act because that provision "simply proscribes certain conduct, and does not in terms create or alter any civil liabilities," and Congress had provided for enforcement by the SEC—both also true of Section 10(b)).

The fact that a private cause of action would not now be implied strongly suggests that "a court must be chary of reading" it expansively by inventing a broad new theory of scheme liability. *Transamerica*, 444 U.S. at 19.[13] The Court recently has recognized that the very concerns about the judicial role that preclude creation by courts of new causes of action also weigh strongly against judicial resolution of complex and contentious policy choices involved in broadly extending an implied cause of action. *Wilkie* v. *Robbins*, 127 S. Ct. 2588, 2597, 2601, 2604 (2007) (declining to imply "a new *Bivens* damages action"; the "difficulty in defining a workable cause of action" meant an implied "cure would be worse than the disease"); see also *id.* at 2608 ("'the heady days in which this Court assumed common-law powers to create causes of action'" are over; existing implied actions should be limited "'to the precise circumstances that they involved'") (Thomas & Scalia, JJ., concurring); *Virginia Bankshares* v. *Sandberg*, 501 U.S. 1083, 1103-1106 (1991); *id.* at 1110 (Scalia, J., concurring).

Determining how the Section 10(b) action should be revised to fit a scheme liability claim is a quintessentially legislative task—one Congress would resolve through trade-offs and compromises—and is unsuited to federal courts "that have not been vested with open-ended lawmaking powers." *Northwest Airlines* v. *Transport Workers*, 451 U.S. 77, 95 (1981); see also *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 579 (1979) (refusing to "legislate" an implied cause of

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[13] The Court does not defer to the SEC's views on "whether a cause of action should be implied by judicial interpretation." *Piper* v. *Chris-Craft Indus.*, 430 U.S. 1, 41 n.27 (1977). See also *Central Bank*, 511 U.S. at 188-191; *Lampf*, 501 U.S. at 361.

action under Exchange Act § 17(a); "'[I]t is not for us to fill any *hiatus* Congress has left in this area'").[14]

E. Scheme Liability Would Overturn *Central Bank*.

Theories of Section 10(b) liability closely resembling plaintiff's scheme theory were routinely invoked to challenge conduct *as aiding and abetting* before *Central Bank*. *E.g.*, *Feldman* v. *Pioneer Petroleum*, 813 F.2d 296, 301 (10th Cir. 1987) (bank "aided and abetted in a conspiracy to promote the scheme" by engaging in a "deceptive transaction to create the false appearance to prospective investors" that a company would obtain loans from the bank); *SEC* v. *Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974) (an "aider and abettor" has "general awareness that his role was part of an overall activity that is improper" and "knowingly and substantially assisted the violation"). Scheme liability was a subspecies of aiding and abetting, not an alternative theory of primary liability.

Central Bank would have been decided differently if involvement in a "scheme" were a proper basis for liability. See 511 U.S. at 200 n.12 (Stevens, J., dissenting) ("conspiracy" claims are now barred). Central Bank was the indenture trustee for a bond issue. It was obliged to ensure compliance with a covenant that the land securing the bonds had an appraised value exceeding the outstanding principal and interest. An indenture trustee (unlike the Vendors here) is a "watchdog" responsible for the protection of the issuer's pub-

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[14] These issues did not arise in pre-*Central Bank* aiding and abetting cases because aiding and abetting liability is by definition derivative of the primary violator's liability. But *Central Bank* requires plaintiff to argue that scheme liability is a form of primary violation; in that context, relying on another violator's conduct to satisfy these elements of the cause of action makes no sense. Indeed, such an approach would confirm that scheme liability is simply another label for aiding and abetting. Courts therefore would have to craft new rules to identify when a scheme liability defendant's actions satisfy each element.

lic investors and its identity is known to investors. See Brief for the U.S., No. 92-854, at 2-3 (May 12, 1992). Central Bank was informed that the issuer's appraisal was grossly inflated. *Id.* at 2. Initially, it ordered a new appraisal, but after meeting with the issuer it secretly "agreed to defer the review" until after the bonds were sold. *Ibid.* The bonds were then "marketed through a fraudulently false and misleading disclosure document" that represented the "appraisal as being correct," and they were soon in default. *Id.* at 3.

As described by the district court in *Central Bank*, plaintiff bond purchasers alleged that the trustee "took affirmative steps to postpone review of the * * * appraisal, a key element in the alleged scheme to defraud." Pet. for Cert., *Central Bank*, No. 92-854, Pet. App. A33. By the trustee's "affirmative action" in agreeing to the delay, it "provided 'substantial assistance' to the fraudulent scheme." Brief for the U.S., *supra*, at 4, 5 n.2; see 511 U.S. at 168-169. There is no doubt that by knowingly accepting a flawed appraisal and certification and halting a new appraisal that would have revealed the inadequacy of the collateral, the trustee would have satisfied plaintiff's test for a primary violation of Section 10(b). The trustee's acts could readily be characterized as a deceptive device that had the "purpose and effect" of creating a false appearance that the appraisal was reliable, which was the *sine qua non* of the fraudulent scheme to sell the bonds.

A test that would convert the aider and abettor in *Central Bank* into a primary violator cannot be correct. Plaintiff's scheme liability theory would make *Central Bank* a dead letter: every peripheral participant would be a primary violator and no one an aider and abettor. Because Congress has ratified *Central Bank* in Section 20(e), that result would frustrate and subvert Congress's informed policy decision.

II. PLAINTIFF'S ARGUMENTS IN FAVOR OF SCHEME LIABILITY ARE MERITLESS.

A. The Vendors Would Not Be Liable At Common Law.

Plaintiff's scheme liability theory receives no support from the common law of deceit. This Court has repeatedly declined to use common law tort standards to define the scope of the implied private action. See *Central Bank*, 511 U.S. at 178, 184 ("[e]ven assuming" a "deeply rooted background of aiding and abetting tort liability, it does not follow that Congress intended to apply that kind of liability to the private causes of action in the securities Acts"); *Blue Chip Stamps*, 421 U.S. at 744-745 (tort law is "light years away from the world of commercial transactions to which Rule 10b-5 is applicable").

Beyond this, the Vendors would not have been liable for deceit in 1934 when Section 10(b) was passed. To be sure, the common law did reach misrepresentations by conduct amounting to an assertion—such as turning back a car's odometer. But key elements of a deceit action are missing here. The complaint does not allege that the Vendors made a misrepresentation to plaintiff, or intended a misrepresentation to reach plaintiff, or owed a duty to disclose to plaintiff, or that plaintiff relied on or was even aware of a misrepresentation by the Vendors.

First, the complaint does not allege that the Vendors—who dealt only with Charter—addressed a misrepresentation to plaintiff. At common law, a corporate insider who issued a fraudulent prospectus to initial stock purchasers was not liable to investors in the secondary market who obtained and relied upon the prospectus.[15] The Restatement adopted this

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[15] *Peek* v. *Gurney*, (1873) L.R. 6 H.L. 377; see *Van Swall* v. *Derschug*, 257 N.Y.S. 206, 207 (App. Div. 1932) (scheme allegations irrelevant because misrepresentations were not addressed to plaintiff); *Greenville Nat'l Bank* v. *National Hardwood Co.*, 217 N.W.

rule, confining liability "to the class to whom the representations are addressed." RESTATEMENT OF TORTS § 531 cmt. d (1938) ("RESTATEMENT"). Plaintiff does not allege that the Vendors addressed any representations to Charter investors.

Second, plaintiff does not allege that the Vendors intended to have Charter convey misrepresentations to investors in order to cause them to buy Charter stock. See RESTATEMENT § 533; compare AC ¶ 196; SAC ¶¶ 10-11, 109, 221. Common law cases required that a misrepresentation be made for the *purpose* of inducing reliance, not merely with *knowledge* that reliance was likely.[16] The Restatement provided that knowledge could support deceit liability generally (§ 531 cmt. a), but it preserved the higher "purpose" standard to limit the scope of liability when—as here—the alleged misrepresentation is relayed to third parties (§ 533). Thus, the maker of a misrepresentation is not liable if he merely "knows that its recipient * * * will to a substantial certainty, repeat it to a third person for the purpose of influencing his conduct" (§ 533 cmt. b).

Finally, the complaint does not allege reliance. The common law required plaintiffs to show "justifiable reliance upon the misrepresentation" in the "type of transaction in which the maker intended to influence their conduct." RESTATEMENT §§ 525, 531. But plaintiff has not alleged that it even knew about the Vendors' advertising transactions with

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786, 786 (Mich. 1928) (no "direct connection between those who claim to have been deceived and those who made the false representations"); Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 239 & n.46 (1933) (citing cases).

[16] *E.g.*, *Dinsmore* v. *National Hardwood Co.*, 208 N.W. 701 (Mich. 1926) (citing cases); *Gillespie* v. *Hunt*, 119 A. 815, 817 (Pa. 1923); *Webb* v. *Rockefeller*, 93 S.W. 772, 776 (Mo. 1906); *Hunnewell* v. *Duxbury*, 28 N.E. 267, 268 (Mass. 1891); W. Page Keeton, *The Ambit of a Fraudulent Representor's Responsibility*, 17 TEX. L. REV. 1, 9 (1938).

Charter, much less that it relied on the Vendors' alleged acts when it traded Charter stock. See *supra*, pp. 17-18.[17]

B. Rule 10b-5(a) And (c) Do Not Expand The Scope Of The Section 10(b) Cause Of Action.

Plaintiff argues (at 24) that Section 10(b) must be read to prohibit conduct beyond the making of false statements or misleading omissions in order to give meaning to clauses (a) and (c) of Rule 10b-5. This Court has made clear, however, that Rule 10b-5 does not expand the coverage of Section 10(b). See *Central Bank*, 511 U.S. at 173 (a "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)"); *Hochfelder*, 425 U.S. at 214 (the "scope [of Rule 10b-5] cannot exceed the power granted the Commission by Congress under § 10(b)").

This Court's decisions concluding that clauses (a) and (c) cover frauds not involving statements do not help plaintiff. Those subsections reach silence and deceptive conduct when there is a violation of a duty truthfully to disclose. *Zandford*, 535 U.S. at 819, 821, 823; *Chiarella*, 445 U.S. at 225 n.5, 230; *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972). They also reach market manipulation. But plaintiff's scheme allegations do not fit these categories.

Nor does plaintiff's claim bear any resemblance to the situation Rule 10b-5 was intended to address. In 1942, the SEC learned that a corporation's president falsely told shareholders that the corporation was losing money and purchased their shares based on the resulting depressed prices. *Hochfelder*, 425 U.S. at 212 n.32. Existing rules against fraud in purchasing securities applied only to brokers and dealers. To close this loophole, the SEC copied a prohibition on fraud in Section 17(a) of the 1933 Act, modified it to in-

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[17] See *Dinsmore*, 208 N.W. at 702 (unless prospective purchaser "knows and relies upon [misrepresentations] when he purchases, it cannot be advanced that he was in any way influenced by them").

clude purchases, and adopted it as a rule pursuant to Section 10(b). *Ibid.*; see 15 U.S.C. § 77q(a). The rule was never intended to police commercial sales agreements.

Plaintiff nevertheless contends that the rule's "scheme" reference drawn from Section 17(a) should be read broadly to cover the Vendors' alleged conduct. But Section 17(a) does not create a private cause of action for fraudulent schemes, and its language differs from that of Section 10(b). As this Court has held repeatedly, "[l]iability under Rule 10b-5 * * * does not extend beyond conduct encompassed by § 10(b)'s prohibition." *O'Hagan*, 521 U.S. at 651. Because plaintiff's allegations do not satisfy the requirements for Section 10(b) liability (*supra*, Part I), Rule 10b-5's scheme language cannot provide a basis for liability here.

C. This Court Has Rejected Broad Interpretations Of Section 10(b) That Exceed Its Language.

Plaintiff cites (Br. 29-31) decisions stating that Section 10(b) and Rule 10b-5 should be construed broadly and flexibly to further their remedial purposes. But this Court has rejected such justifications for reading the securities laws expansively, focusing instead on the statutory text and refusing to broaden the implied private action. See *Central Bank*, 511 U.S. at 188 ("[p]olicy considerations cannot override our interpretation of the text and structure of the Act"); *Hochfelder*, 425 U.S. at 198-200, 218 n.33; *Blue Chip Stamps*, 421 U.S. at 739-744, 747-749; see also *Board of Governors* v. *Dimension Fin. Corp.*, 474 U.S. 361, 373-374 (1986) (discussing problems with applying broad legislative purposes at expense of specific provisions).

Plaintiff also misreads this Court's decisions. In *Superintendent of Insurance* v. *Bankers Life*, 404 U.S. 6, 7-12 (1971), the Court held that the plaintiff company stated a claim against new controlling stockholders and directors who allegedly "duped" the company by liquidating securities and stealing the proceeds without disclosure. The Court did not

rule on whether "outside collaborators," including banks that had handled the transactions and the company's former owner, could be liable for the fraud. *Id.* at 10, 13.

Herman & MacLean v. *Huddleston*, 459 U.S. 375 (1983), does not extend Section 10(b) to reach a person who causes a misrepresentation to be made that is not attributed to that person. The passage plaintiff cites (at 30) simply points out that an accountant could not be sued under Section 11 for a misrepresentation in a registration statement that it had not "prepared or certified," while "any person" who "participat[ed] in the registration statement" and met the other statutory requirements might be sued under Section 10(b). *Id.* at 386 n.22. Plaintiff has not alleged that the Vendors participated in preparing Charter's financial statements, and its claim does not meet the essential requirements of Section 10(b).

In *Wharf (Holdings) Ltd.* v. *United Int'l Holdings, Inc.*, 532 U.S. 588 (2001) (cited by plaintiff at 30-31), this Court held that Wharf's secret intent not to honor an option it sold to an investor was a misrepresentation, because "a promise necessarily carries with it the implied assertion of an intention to perform." *Id.* at 596 (quoting RESTATEMENT (SECOND) OF TORTS § 530 cmt. c (1976)). In this case, the Vendors made no assertions whatsoever to plaintiff. Accordingly, this Court's precedents do not support plaintiff's claim.

III. BROAD SCHEME LIABILITY FOR SECONDARY ACTORS WOULD HARM U.S. SECURITIES MARKETS AND IS UNNECESSARY TO DETER MISCONDUCT OR COMPENSATE INVESTORS.

Ultimately, plaintiff and its *amici* maintain that scheme liability is necessary to deter fraud and protect the integrity of the capital markets. Even if correct, that contention could not carry the day; "[p]olicy considerations cannot override" the "text and structure of the Act." *Central Bank*, 511 U.S. at 188. But plaintiff's argument is wrong on its own terms: scheme liability would *undermine* securities markets, *dam-*

age the economy, and *injure* investors, while doing nothing to deter fraud. Insofar as "practical factors" are relevant (*Blue Chip Stamps*, 421 U.S. at 749), "the inexorable broadening" of liability would "result in more harm than good." *Id.* at 747-748. These practical considerations show, as in *Central Bank*, that any decision to expand liability to new classes of defendants should be left to Congress.

A. Scheme Liability Would Encourage Wasteful And Meritless Litigation, Damaging The Economy.

1. There is no doubt that "[p]rivate securities fraud actions, * * * if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law." *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007). The Court has noted "that 'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general. * * * Even weak cases brought under the Rule may have substantial settlement value'" because "'[t]he very pendency of the lawsuit may frustrate or delay normal business activity.'" *Dabit*, 547 U.S. at 80. Opportunities for abusive discovery, often described as a kind of "financial blood letting" (Kassis, *The Private Securities Litigation Reform Act*, 26 SETON HALL LEGIS. J. 119, 124 (2001)), "may likewise exist in this type of case to a greater extent than they do in other litigation." *Blue Chip Stamps*, 421 U.S. at 741.

The costly disruption caused by a securities fraud suit thus "represent[s] an *in terrorem* increment of the settlement value" that gives even an insubstantial complaint "a settlement value to the plaintiff out of any proportion to its prospect of success at trial." *Blue Chip Stamps*, 421 U.S. at 740-741. This effect is so pronounced that defendants settle virtually *every* securities fraud claim that survives a motion to dismiss. See Br. for the United States as Amicus Curiae at 22, *Tellabs, Inc.* v. *Makor Issues & Rights*, No. 06-484 (Feb.

9, 2007) ("practical reality" is that if a securities case is not dismissed it "will never reach an adjudication on the merits"). That reality denies defendants an opportunity to contest the merits and encourages plaintiffs to bring meritless suits.

2. These harms to the economy would be aggravated by scheme liability. Scheme litigation would greatly expand the categories of targeted defendants, permitting suit against limitless numbers of counter-parties with no direct connection to market activity. Such defendants would be "prime targets of abusive securities lawsuits" because "[t]he deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant." S. Rep. No. 104-98, at 9 (1995). To protect themselves, defendants would be forced to plead in all other potential secondary actors, even if plaintiffs did not.

Recognizing scheme liability would also greatly expand the range of transactions that could give rise to suit. Innumerable legitimate business arrangements—for example, those involving derivatives, swaps, or barter exchanges—are governed by complex and sometimes ambiguous accounting rules. See p. 6 & n.5, *supra*. Plaintiffs would have little difficulty drafting complaints that portray them as improper.

The problem is compounded by the characteristics of scheme litigation. A rule that hinges liability on "purpose and effect" would raise factual disputes in every case, making it uniquely difficult for innocent defendants to obtain an early dismissal—and thus to escape coerced settlement. The availability of joint and several liability, meanwhile, would place scheme defendants at risk of enormous damages out of proportion to the actor's involvement in the alleged wrongdoing. This combination of dismissal-proof allegations and disproportionate liability means that, when "peripheral defendants are sued, the pressure to settle [will be] overwhelming." S. Rep. No. 104-98, at 21. See *Central Bank*, 511 U.S. at 189.

If history and common sense are guides, these factors—a vast array of new defendants, astronomical potential liability,

and a nebulous liability standard—mean scheme liability would "'allow a relatively high proportion'" of "'bad'" cases into court. "'The risk of strike suits is particularly high in such cases.'" *Blue Chip Stamps*, 421 U.S. at 742. As Justice Powell noted in similar circumstances, "[a] rule allowing this type of open-ended litigation would itself be an invitation to fraud." *Id.* at 761 (Powell, J., concurring). "'The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.'" *Id.* at 748.

3. Scheme liability would harm investors. One obvious component of this injury would be the direct costs of litigation imposed upon shareholders of companies that are swept up in scheme allegations. The "enormous size of [coerced] settlement values" is well known. INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 74 (rev. Dec. 5, 2006) ("INTERIM REPORT"), *available at* http://tinyurl.com/yqdy8n. Other direct costs could be even more substantial. The best empirical data, studying settlements in almost 500 post-PSLRA suits, found that the mere filing of securities fraud litigation caused $25 billion in shareholder wealth to be "wiped out just due to litigation" in the actions studied. THAKOR, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 14 (U.S. Chamber of Commerce Institute for Legal Reform 2005), *available at* http://tinyurl.com/2vz397.

These direct costs are only the tip of the iceberg. The litigation risks posed by scheme liability would have "ripple effects" throughout the economy. *Central Bank*, 511 U.S. at 189. A rule that threatens to impose staggering liability on a supplier whose transactions are misstated by an issuer would make it less attractive to do business with the most innovative and entrepreneurial companies, whose volatile share prices invite litigation; would make small deals with large companies unattractive because (as in this case) the tradeoff for a small profit could be liability for huge market losses; and would lead suppliers to build a risk premium into their

prices, to the ultimate detriment of investors and consumers and to the benefit of foreign competitors.

Scheme liability also would threaten the professionals whose services are essential to capital formation, causing all to raise prices and some to decline higher-risk engagements. See S. Rep. No. 104-98, at 9, 21-22. The difficulty of obtaining high-quality professional services would fall on "newer and smaller companies," as "business failure would generate securities litigation against the professional, among others." *Central Bank*, 511 U.S. at 189. This would "ad[d] significantly to the cost of raising capital" (S. Rep. No. 104-98, at 9), causing injury to "'the entire U.S. economy.'" *Dabit*, 547 U.S. at 81.

Vague liability rules also worsen the competitive position of American markets. Bipartisan studies have found that "the United States is losing its leading competitive position" compared to markets abroad, in large part due to escalating "liability risks." INTERIM REPORT at ix-x, 2-3, 29-34; accord BLOOMBERG & SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP ii, 5, 12 (Dec. 2006), *available at* http://tinyurl.com/2fhyuf. "Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market." INTERIM REPORT at 11, 71. Insurance costs for Fortune 500 companies are six times higher here than in Europe. *Id.* at 71. Given the importance of "certainty and predictability" in this area (*Central Bank*, 511 U.S. at 188), vague theories of scheme liability could only exacerbate these disparities. See *Hearing of the House Financial Services Committee on the State of the International Financial Services System* (June 20, 2007) (the lack of "clear lines" for "primary liability" is "a risk to our economy, to our competitiveness, to jobs") (testimony of Treasury Secretary Henry Paulson).

B. Scheme Liability Is Not Necessary To Deter Fraud Or Compensate Investors.

Plaintiff and its *amici* maintain that the harms that would be imposed by scheme liability must be endured in the interest of deterring fraud. This assertion is wrong. Private civil liability is not necessary to combat wrongdoing by secondary actors—and would not be effective in doing so.

1. Deterrence of misconduct in the securities markets is accomplished principally by *public* enforcement. In fact, "[t]he United States has the toughest administrative enforcement of securities laws in the world." INTERIM REPORT at 71. The lead role in this regard, of course, is taken by the SEC, which employs a broad range of statutory and administrative tools to combat fraud. As we have explained, Congress enacted Exchange Act § 20(e) specifically to authorize civil actions by the SEC against aiders and abettors. Because the SEC is not required to establish reliance or causation, its actions will be much more effective than private litigants' "scheme" claims. In addition, the SEC may obtain injunctive relief, administrative orders against aiders and abettors, orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of any gain. See 15 U.S.C. §§ 78u, 78u-3; 4 BROMBERG & LOWENFELS § 7:307, at 7-503. The Commission also may invoke other statutory bases for relief against secondary actors, such as Section 17(a)(3) of the Securities Act, 15 U.S.C. § 77q(a)(3) (proscribing fraudulent "transaction, practice, or course of business").

The SEC has not been shy in using these powers. During 2006, the Commission's 900-person enforcement staff initiated over 900 investigations, brought 218 suits and 356 administrative proceedings, and obtained orders requiring payment of more than $3.3 billion in disgorgement and penalties. SEC 2006 Performance and Accountability Report at 8, *available at* http://tinyurl.com/ygyfv8. Of particular im-

portance, Congress in 2002 authorized the Commission to combine civil penalties and disgorgements into a "Fair Fund" to provide compensation to defrauded investors. 15 U.S.C. § 7246. In total, the Commission has recovered more than $8 billion for investors since receiving this authority. SEC 2006 Performance and Accountability Report at 23. See Greg Stohr, *Bush Administration Rebuffs Investors at High Court*, Bloomberg (June 12, 2007) ("We think the SEC is the right entity to bring those lawsuits," quoting Allan Hubbard, director of the Administration's National Economic Council).

In addition, securities fraud is a criminal violation punishable by fines and imprisonment. See, *e.g.*, 15 U.S.C. § 78ff. The Department of Justice, assisted by the FBI, enforces these laws aggressively: its Corporate Fraud Task Force has obtained more than 1200 guilty pleas and convictions since July 2002, and more than $1 billion in forfeitures used to compensate investors. Department of Justice, Fact Sheet: President's Corporate Fraud Task Force (July 17, 2007), *available at* http://tinyurl.com/37hudk. These federal efforts are supplemented by state prosecutors who have been vigorous in challenging fraud. See, *e.g.*, http://oag.state.ny.us/press/agpress04.html (New York Attorney General obtained more than $1 billion in settlements in 2004 alone). These enforcement mechanisms are far-reaching and effective and are the real deterrent to fraud by corporate officials.

2. Public enforcement actions effectively serve the goals of deterrence and compensation. Private class actions do not. *First*, "the deterrent effect [of class actions] is weak" when "the merits of claims" are "irrelevant to their initiation or settlement values." Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 952 (1993).[18] When

[18] The principal predictors of whether suit will be brought and the size of the ultimate settlement are declines in stock price and the amount of the defendant's insurance coverage. Garry *et al.*, *The*

all cases that survive a motion to dismiss are settled, litigation and settlement costs become costs of doing business, not a sign of wrongdoing. And any deterrent effect is vitiated by the most salient characteristic of the securities fraud class action: penalties fall not on individual wrongdoers but "on the corporation and its insurer, which means that they are ultimately borne by the shareholders." INTERIM REPORT at 78.

Second, these damages provide no real compensation to investors. The average securities fraud suit settles for two to three percent of investors' alleged losses, with one-third of that skimmed off the top by plaintiffs' counsel and defense costs (absorbed by current shareholders) usually amounting to another 25 to 35 percent of the settlement value. Coffee, *Reforming the Securities Class Action*, 106 COLUM. L. REV. 1534, 1545-1546 (2006). If one adds the "costs of D&O insurance and business disruption, it is not clear that there is *any* positive recovery." INTERIM REPORT at 79 (emphasis added). See Coffee, *supra*, 106 COLUM. L. REV. at 1559.

Third, even this overstates the value of class action recoveries. Forty years ago, Judge Friendly expressed the concern that expansive securities fraud liability "'will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.'" *Blue Chip Stamps*, 421 U.S. at 739 (quoting *SEC* v. *Texas Gulf Sulphur*, 401 F.2d 833, 867 (2d Cir. 1968)). That warning has proved accurate. Virtually all commentators now recognize that, over time, a diversified investor buys and sells in roughly equal amounts, meaning that securities fraud settlements simply "transfe[r] money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick

---

Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform, 49 S.D. L. REV. 275, 287 n.98 (2004) (citing studies). However useful in individual cases, the PSLRA has not solved this systemic problem. Settlement costs are now at an all-time high. See BLOOMBERG & SCHUMER, at 74.

up." Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1503 (1996).[19]

In such a regime, securities fraud litigation serves only as "a grotesquely inefficient form of insurance against large stock market losses." Alexander, *Do the Merits Matter?*, 43 STAN. L. REV. 497, 501 (1991). And that already grotesque inefficiency would carry an especially harmful consequence in the context of scheme liability: *plaintiff here would have the Vendors' innocent shareholders compensate Charter's shareholders for a fraud committed by Charter's own management.* See *Piper* v. *Chris-Craft Indus.*, 430 U.S. 1, 39 (1977) (refusing to imply a cause of action where "shareholders" would bear "the burden of any judgment" and damages would benefit "the very party whose activities Congress intended to curb"). That outcome would pervert the purposes of Section 10(b) and Rule 10b-5, which manifestly were not intended "to provide investors with broad insurance against market losses." *Dura*, 544 U.S. at 345. As in *Central Bank*, plaintiff's attempt here to vastly expand the scope of private securities fraud liability would "disserve the goals of fair dealing and efficiency in the securities markets." 511 U.S. at 188. It should be rejected.

CONCLUSION

The judgment of the court of appeals should be affirmed.

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[19] As a result, "recoveries from class action litigation represent a windfall to large investors." Alexander, *supra*, 48 STAN. L. REV. at 1502. See INTERIM REPORT at 79; EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339-340 (1991). In contrast, "small undiversified investors are seldom likely to receive a monetary benefit from the securities class action" because "buy and hold" investors are "more likely to have purchased * * * stock before the class period commenced." Coffee, 106 COLUM. L. REV. at 1559-1560. Thus "securities litigation systematically may transfer wealth from buy and hold investors to more actively trading investors." INTERIM REPORT at 80.

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AUGUST 2007

STATUTORY AND REGULATORY ADDENDUM

1. Section 10(b) and Rule 10b-5

Securities Exchange Act § 10, 15 U.S.C. § 78j.
Manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * *

---

17 C.F.R. § 240.10b-5.
Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make

the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

2. Control person provisions

Securities Exchange Act § 20, 15 U.S.C. § 78t. Liability of controlling persons and persons who aid and abet violations.

(a) Joint and several liability; good faith defense

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

* * *

(e) Prosecution of persons who aid and abet violations

For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title [15 U.S.C. § 78u(d)(1) or (3)], any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

Securities Act § 2, 15 U.S.C. § 77b.
Definitions; promotion of efficiency, competition, and capital formation.

(a) Definitions

* * *

(11) * * * As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

17 C.F.R. § 240.12b-2.
Definitions.

* * *

Control. The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

3. Loss causation and proportionate liability provisions

Securities Exchange Act § 21D, 15 U.S.C. § 78u-4. Private securities litigation.

* * *

(b) Requirements for securities fraud actions

* * *

(4) Loss causation

In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

* * *

(f) Proportionate liability

(1) Applicability

Nothing in this subsection shall be construed to create, affect, or in any manner modify, the standard for liability associated with any action arising under the securities laws.

(2) Liability for damages

(A) Joint and several liability. Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.

* * *

4. Fair funds provision

Sarbanes-Oxley Act § 308, 15 U.S.C. § 7246.
Fair funds for investors.

(a) Civil penalties added to disgorgement funds for the relief of victims

If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in section 78c(a)(47) of this title) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

* * *

5. Other antifraud provisions

Securities Act § 11, 15 U.S.C. § 77k.
Civil liabilities on account of false registration statement.

(a) Persons possessing cause of action; persons liable

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement, in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

* * *

Securities Act § 12, 15 U.S.C. § 77*l*.
Civil liabilities arising in connection with prospectuses and communications.

(a) In general. Any person who—

(1) offers or sells a security in violation of section 5 [15 U.S.C. § 77e], or

(2) offers or sells a security (whether or not exempted by the provisions of section 3 [15 U.S.C. § 77c], other than paragraphs (2) and (14) of subsection (a) thereof), by the use of any means or instruments of transportation or

communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

(b) Loss causation

In an action described in subsection (a)(2), if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

Securities Act § 17, 15 U.S.C. § 77q.
Fraudulent interstate transactions.

(a) Use of interstate commerce for purpose of fraud or deceit

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as de-

fined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

* * *

Securities Exchange Act § 9, 15 U.S.C. § 78i.
Manipulation of security prices.

(a) Transactions relating to purchase or sale of security

It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange—

(1) For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of such security with the

knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange or in connection with any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) with respect to such security creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

(3) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) with respect to such security, to induce the purchase or sale of any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) with respect to such security by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(4) If a dealer or broker, or the person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section

206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) with respect to such security, to make, regarding any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) with respect to such security, for the purpose of inducing the purchase or sale of such security or such security-based swap agreement, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

(5) For a consideration, received directly or indirectly from a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) with respect to such security, to induce the purchase of any security registered on a national securities exchange or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C. § 78c note]) with respect to such security by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(6) To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * *

(e) Persons liable; suits at law or in equity

Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment. No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

* * *

Securities Exchange Act § 18, 15 U.S.C. § 78r.
Liability for misleading statements.

(a) Persons liable; persons entitled to recover; defense of good faith; suit at law or in equity; costs, etc.

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder, or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title [15 U.S.C. § 78o(d)], which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any

person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

(43)

8-31-07

No. 06-43

In the Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

SUPPLEMENTAL BRIEF FOR RESPONDENTS

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SUPPLEMENTAL BRIEF FOR RESPONDENTS

Pursuant to this Court's Rule 25.5, respondents submit this supplemental brief to address issues regarding the record that have been raised by the Solicitor General's brief for the United States. See generally Stern, Gressman, Shapiro, & Geller, SUPREME COURT PRACTICE (8th ed. 2002), at 666-667; see also *id.* at 464.

In their brief, respondents advance several arguments in support of the judgment below, including those based on reliance; the language of Section 10(b) ("use or employ" a "deceptive device" "in connection with" a securities transaction); Congress's rejection of a private right of action for aiding and abetting when it enacted Section 20(e); and loss causation. Although agreeing with respondents that the decision below should be affirmed, the Solicitor General suggests that certain of these arguments were not fully presented below. That suggestion overlooks important elements of the record.

In particular, the Solicitor General states that "[r]espondents did not seek dismissal in the district court on the ground that the 'in connection with' requirement was satisfied, and neither of the courts below addressed that question." U.S. Br. 16 n.7. In fact, the argument *was* presented to both courts below.[1] There accordingly can be no doubt that

[1] See, *e.g.*, Scientific-Atlanta Mot. To Dismiss Br. 16 ("Plaintiff has utterly failed to properly plead," among other things, that respondents "caused Plaintiff economic harm in connection with the purchase and sale of a security"); Scientific-Atlanta Br. in Opp. to Mot. To Amend and Reconsider Dismissal 8 n.4 ("the requisite connection between S-A's alleged conduct and the purchase or sale of Charter securities is lacking"; plaintiff's claim "overlook[s] th[e] mandatory 'in connection with' requirement"); Scientific-Atlanta CA8 Br. 22-23 ("A commercial transaction unconnected to the purchase or sale of a security cannot fall within Section 10(b) simply because the party standing on the other side of the transaction was a public company whose stock was purchased and sold by

the Court may rely upon petitioner's failure to satisfy the "in connection with" requirement of Section 10(b) in affirming the Eighth Circuit's judgment: a respondent "is entitled under [this Court's] precedents to urge any ground which would lend support to the judgment below" (*Dayton Board of Education* v. *Brinkman*, 433 U.S. 406, 419 (1977)), "whether or not that ground was relied upon, rejected, or even considered by the District Court or the Court of Appeals." *Washington* v. *Yakima Indian Nation*, 439 U.S. 463, 476 n.20 (1979). See Stern, Gressman, Shapiro, & Geller, at 444-445 (citing cases).

Similarly, the Solicitor General fails to present a full picture when he states in passing that respondents "did not separately raise the issue [of loss causation] in the court of appeals." U.S. Br. 25 n.15. Although it is true that respondents did not advance a loss causation argument under a separate heading in their appellate briefs, they did present loss causation as a ground for dismissal, both in their briefs to the Eighth Circuit and at oral argument. See Scientific-Atlanta CA8 Br. 22 (plaintiff "was not harmed by the existence" of the Vendors' agreements with Charter); oral arg. Tr. 13 ("broad, tort-based causality determinations are not the same as the statutory scheme under Section 10(b)")[2]; see also Scientific-Atlanta Mot. To Dismiss Br. 20 ("The Complaint also fails to allege specific facts showing that Scientific-Atlanta proximately caused the economic harm that Plaintiff alleges it suffered"). The Solicitor General does correctly recognize that the complaint in this case "fails sufficiently to allege loss

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investors from time to time."); see also Motorola Mot. to Dismiss Br. 2, 8 (incorporating Scientific-Atlanta arguments).

[2] There is no official transcript of the Eighth Circuit oral argument. The citation in text is to a transcript prepared by respondents from the Eighth Circuit's recording of the argument. The recording is accessible at http://www.ca8.uscourts.gov/oralargs/oaFrame.html., No. 05-1974.

causation" (U.S. Br. 26) and that the Court may affirm the Eighth Circuit's decision on that ground. *Id.* at 25 n.15.[3]

Finally, the Solicitor General's brief demonstrates why the Eighth Circuit's decision should be affirmed whether or not the contracts procured by Charter "misle[]d Charter's outside accountant.'" U.S. Br. 17, 17-30. See also 15 U.S.C. § 7242 (emphasis added) (Sarbanes Oxley law, in addition to refusing to restore private aiding and abetting claims, provides that efforts to "mislead any independent public or certified accountant" shall be dealt with solely by the SEC: "In any civil proceeding, the Commission shall have *exclusive* authority to enforce this section and any rule or regulation issued under this section"). But the Court should bear in mind that neither the first nor the second amended complaint alleges that the Vendors had *any* dealings or communications with Arthur Andersen. The complaints fail to allege facts showing that the Vendors initiated or encouraged Charter's multi-faceted fraud, or that any statement or act of the Vendors was relied upon, or even known to, any member of the investing public.[4]

[3] There is no doubt that the other grounds for affirmance argued by respondents were fully presented below. See, *e.g.*, Scientific-Atlanta CA8 Br. 9, 25-28 (reliance); Motorola CA8 Br. 15-16 (reliance); Scientific-Atlanta Mot. To Dismiss 19-20 (reliance); Scientific-Atlanta CA8 Br. 14 n.6 (Section 20(e)); Motorola CA8 Br. 19 (Section 20(e)). Moreover, as the Solicitor General notes (U.S. Br. 6, 7, 18 n.9), both the district court and the court of appeals accepted the Vendors' submission that plaintiff did not establish reliance.

[4] Respondents agree with the Solicitor General (Br. 11-17) that "nonverbal deceptive conduct" can violate Section 10(b), where all the prerequisites of primary liability are satisfied. Resp. Br. 21-22. But merely alleging a deceptive scheme does not suffice. SG Br. 17-30. In *Central Bank*, plaintiff argued unsuccessfully to this Court (1993 WL 13006274, at *1) that "Central Bank provided critical assistance to the fraudulent scheme by taking affirmative

For the foregoing reasons and those stated in respondents' brief, the decision of the court of appeals should be affirmed.

Respectfully submitted.

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AUGUST 2007

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steps to ensure that the shortage of collateral and the defects of the appraisal would be hidden from plaintiffs," that it participated in "a concealed side agreement" to implement "the fraudulent scheme" (*id.* at *7), that it had "extensive involvement in the issuance of the 1988 bonds" (*ibid.*), and that it acted "knowingly or recklessly" (*id.* at *1). See *Central Bank* complaint ¶¶ 52, 64 (plaintiff "trusted" that Central Bank would perform as indenture trustee without engaging in the fraudulent "conspiracy" and "scheme"). These characterizations did not transform Central Bank into a primary violator.

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No. 06-43

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In the Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
PETITIONER

v.

SCIENTIFIC-ATLANTA, INC., ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING AFFIRMANCE

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QUESTION PRESENTED

Whether a person may be liable in a private action under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5(a) and (c) thereunder, 17 C.F.R. 240.10b-5(a) and (c), for engaging in a transaction with the issuer of a security on the ground that the transaction constituted "deceptive" conduct, when the plaintiff did not rely on that conduct but at most relied only on a subsequent misstatement by the issuer concerning the transaction.

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In the Supreme Court of the United States

No. 06-43

STONERIDGE INVESTMENT PARTNERS, LLC,
PETITIONER

v.

SCIENTIFIC-ATLANTA, INC., ET AL.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING AFFIRMANCE

INTEREST OF THE UNITED STATES

The United States administers and enforces the federal securities laws. The question in this case concerns the scope of liability in private actions under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b). Meritorious private actions are an essential supplement to criminal prosecutions and civil enforcement actions brought by the government. At the same time, private securities actions can be abused in ways that impose substantial costs on companies that have fully complied with the applicable laws. The United States also has responsibility, through, *inter alia*, the federal banking agencies, for ensuring that entities providing services to publicly traded companies are not subject to inappropriate secondary liability. The United States thus has a strong interest in seeing that the principles applied in private actions

promote the purposes of the securities laws and other important federal laws, and has previously participated as an amicus curiae in cases involving those principles.

STATEMENT

1. This case involves a claim of securities fraud against respondents Scientific-Atlanta, Inc., and Motorola, Inc., which manufacture digital set-top boxes used by cable-television subscribers. As alleged in the amended complaint, the facts are as follows. Respondents supplied set-top boxes to Charter Communications, Inc. (Charter), one of the Nation's largest cable-television operators. In August 2000, Charter realized that it was unlikely to meet its annual target for operating cash flow. Charter decided to ask respondents to enter into "wash" transactions, whereby Charter would pay respondents additional amounts for the set-top boxes they supplied and respondents would use those amounts to "purchase" advertising on Charter's cable channels. In effect, those transactions would entitle respondents to receive the advertising for free. Scientific-Atlanta Br. in Opp. App. 31-32.

In order for Charter to improve its operating cash flow as a result of those transactions, it needed to capitalize the payments to respondents (on the theory that they were for the purchase of equipment) while treating the return payments from respondents as revenue (on the theory that they were for the purchase of advertising). Before entering into the transactions, Charter discussed them with Arthur Andersen, its outside accountant. Arthur Andersen advised Charter that it could not recognize the advertising payments as revenue if they were integrally related to the payments to respondents, but that it could do so if the two sets of payments were unrelated to each other, negotiated at least one month apart, and made at fair market value. Charter informed Arthur Andersen that it would undertake to satisfy those conditions. In

late September 2000, Charter and each respondent entered into separate agreements for the price increase in the set-top boxes and for the advertising; the agreements concerning the set-top boxes, however, were backdated to August 2000. Scientific-Atlanta Br. in Opp. App. 32-34.

The proposed second amended complaint, based on information obtained in discovery, contains more detailed allegations concerning the transactions.[1] It alleges that Charter instructed Scientific-Atlanta to notify Charter that it was raising the price of set-top boxes that Charter had already agreed to purchase, and further instructed Scientific-Atlanta to cite higher manufacturing costs as the reason for the increase. Scientific-Atlanta followed Charter's instructions, even though it knew that the stated reason for the increase was false. The parties later entered into an agreement under which Charter would pay an extra $20 for each set-top box it had already agreed to purchase (totaling $6.73 million in excess payments). The parties simultaneously entered into a separate agreement in which Scientific-Atlanta agreed to purchase $6.73 million in advertising from Charter (at rates four to five times higher than those paid by other advertisers). J.A. 53a-59a.

The proposed second amended complaint also alleges that Charter entered into an agreement with Motorola to purchase 540,000 set-top boxes by December 31, 2000, even though Charter had no present need for the Motorola boxes (and thus no intention of buying them). The agreement contained a provision requiring Charter to pay Motorola $20 per box in liquidated damages (totaling $10.8 million) if it did not pur-

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[1] After the district court had dismissed the claim against respondents, petitioner filed a motion for leave to file the proposed second amended complaint. The district court denied the motion in relevant part, concluding that, in light of its reasoning in dismissing the claim, "amending the complaint would be futile." Pet. App. 28a.

chase the boxes by the specified date. The parties entered into a separate agreement in which Motorola agreed to purchase $10.8 million in advertising from Charter (again at rates four to five times higher than those paid by other advertisers). J.A. 53a, 56a-59a.

The proposed second amended complaint alleges that respondents knew that Charter intended to use the transactions artificially to inflate its operating cash flow. It also alleges that the backdating of the contracts for the set-top boxes was indicative of "[respondents'] scienter and complicity in efforts to mislead Charter's auditors." J.A. 53a, 55a, 58a-60a.

Charter subsequently informed Arthur Andersen that the agreements had been negotiated a month apart from each other, and Arthur Andersen duly advised Charter that it could recognize the advertising payments as revenue. Charter did so in its financial statements for the fourth quarter of 2000, thereby increasing its operating cash flow by at least $17 million to a total of $433.2 million (and $1.56 billion for the entire year). But for its accounting of the transactions with respondents, Charter would not have met analysts' projections for its operating cash flow. Charter continued to report increases in cash flow throughout 2001 and the first quarter of 2002. On April 1, 2003, however, Charter issued a comprehensive restatement of its financial reports in which, *inter alia*, it reduced its operating cash flow for 2000 by $195 million and its operating cash flow for 2001 by $292 million. Scientific-Atlanta Br. in Opp. App. 33-34, 47, 49-60, 66.[2]

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[2] The Securities and Exchange Commission (SEC) subsequently brought administrative proceedings against Charter; in its order instituting the proceedings, the SEC alleged that, as a result of the transactions at issue in this case, Charter had committed numerous reporting, books and records, and accounting control violations. See *In re Charter Commc'ns, Inc.*, Exchange Act Release No. 50,098 (July 27, 2004) <http://sec.gov/litigation/admin/34-50098.htm>. Charter settled the proceedings without admitting or denying any securities violations.

2. As is relevant here, petitioner, an investment firm, filed a class action against respondents in the United States District Court for the Eastern District of Missouri on behalf of all purchasers of Charter securities between November 8, 1999, and July 17, 2002, alleging that respondents had engaged in fraudulent conduct in violation of Section 10(b) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. 78j(b), and Rule 10b-5(a) and (c) thereunder, 17 C.F.R. 240.10b-5(a) and (c).[3] Petitioner also brought claims against Charter and its executives, contending that Charter had engaged in numerous fraudulent acts to misrepresent its revenues and costs and to inflate its customer growth rate, and against Arthur Andersen, contending that Arthur Andersen had acted fraudulently in auditing Charter's financial statements. Scientific-Atlanta Br. in Opp. App. 1-88.[4]

Respondents filed motions to dismiss, contending, *inter alia*, that the complaint failed to allege actionable misstatements or omissions by respondents, and also failed to allege that petitioner had relied on respondents' alleged deceptions. The district court granted the motions. Pet. App. 30a-71a. The court held that "[petitioner's] claims against [respondents] amount to claims for aiding and abetting liability under § 10(b) and Rule 10b-5," and were therefore barred by *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which held that a private party may not pursue a Section 10(b) action on a theory of aiding and

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[3] Petitioner originally also alleged that respondents had made misstatements in violation of Rule 10b-5(b), 17 C.F.R. 240.10b-5(b), see Scientific-Atlanta Br. in Opp. App. 80, but dropped that claim in its second amended complaint, see J.A. 110a.

[4] Charter and its executives entered into a settlement. Arthur Andersen moved to dismiss the claim against it, contending that the complaint did not sufficiently allege scienter, but the district court denied the motion. Pet. App. 47a-64a. Arthur Andersen subsequently also entered into a settlement.

abetting liability. Pet. App. 39a. The district court reasoned that "[petitioner] do[es] not assert that [respondents] made any statement, omission or action at issue or that [petitioner] relied on any statement, omission or action made by either of them." *Id.* at 41a. Instead, the court noted, "[petitioner] contend[s] that [respondents] are liable to Charter's investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for." *Ibid.* The court stated that it could "find no precedent" for the proposition that a company could violate Section 10(b) and Rule 10b-5 simply "by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue." *Id.* at 41a-42a.

3. The court of appeals affirmed. Pet. App. 1a-11a. At the outset, the court of appeals stated that, in *Central Bank*, this Court "confirmed that § 10(b) prohibits only 'manipulative or deceptive' devices or contrivances," and that, in earlier cases, the Court "held that 'deceptive' conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose." *Id.* at 4a-5a (citation omitted). The court of appeals further noted that, in *Central Bank*, this Court held that "Rule 10b-5 does not reach those who only aid or abet a violation of § 10(b)." *Id.* at 5a.

The court of appeals rejected petitioner's contention that it had "properly alleged a *primary* violation of the securities laws within the meaning of *Central Bank* because [respondents] violated Rule 10b-5(a) and (c)," Pet. App. 8a, which prohibit "employ[ing] [a] device, scheme, or artifice to defraud" or "engag[ing] in [an] act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." The court reasoned that "*Central Bank* and the earlier cases on which it relied stand for three governing principles." *Ibid.* First, the court explained, "a private plaintiff may not bring a 10b-5 suit against a defendant for

acts not prohibited by the text of § 10(b)." *Ibid.* (internal quotation marks and citation omitted). Second, the court contended, "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *Ibid.* (citation omitted). Third, the court noted, "[t]he term 'manipulative' in § 10(b) has [a] limited contextual meaning." *Ibid.* (citation omitted). Based on those principles, the court held that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." *Id.* at 9a.

Applying that holding, the court of appeals determined that petitioner's complaint failed to state a claim against respondents. Pet. App. 9a-10a. The court reasoned that "the focus of [petitioner's] § 10(b) and Rule 10b-5 claims was deception" by Charter, and that "neither Motorola nor Scientific-Atlanta was alleged to have engaged in any * * * deceptive act." *Ibid.* In addition, the court held that respondents "did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." *Id.* at 10a. The court thus concluded that "the district court properly dismissed the claims against [respondents] as nothing more than claims, barred by *Central Bank*, that [respondents] knowingly aided and abetted the Charter defendants in deceiving the investor [class]." *Ibid.*

The court of appeals stated that it was "aware of no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts." Pet. App. 10a. Imposing liability in those circumstances, the court

concluded, "would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings," and "[d]ecisions of this magnitude should be made by Congress." *Ibid.*

SUMMARY OF ARGUMENT

A. The court of appeals in this case erred to the extent it held that Section 10(b) of the 1934 Act, 15 U.S.C. 78j(b), reaches only misstatements, omissions made while under a duty to disclose, or manipulative trading practices. The plain language of Section 10(b) demonstrates that it potentially reaches *all* conduct that is "manipulative" or "deceptive." That interpretation is consistent both with the legislative history of the 1934 Act and with the contemporaneous understanding of the term "deceptive." This Court's cases provide no support for the conclusion that non-verbal deceptive conduct is somehow beyond the reach of Section 10(b).

Properly understood, a person engages in "deceptive" conduct for purposes of Section 10(b) when the conduct by its nature is objectively likely to mislead another person, *e.g.*, when it has the effect of conveying a false appearance of material fact to an observer (assuming, of course, that the defendant possessed the requisite mental state in engaging in the conduct). Respondents' alleged conduct constituted a "deceptive device or contrivance" because it not only was likely to, but allegedly did, mislead Charter's outside accountant, Arthur Andersen, about the nature of the transactions into which respondents had entered. Such a reading of Section 10(b) does not nullify this Court's holding in *Central Bank* that aiding and abetting liability is not available in a private Section 10(b) action, because a person cannot be liable as a primary violator unless it *itself* engages in deceptive conduct—and, critically, unless the other elements of primary liability under Section 10(b) are also established.

B. Although the court of appeals erred by concluding that petitioner had failed to satisfy Section 10(b)'s deception requirement, it nevertheless correctly upheld the district court's dismissal of petitioner's complaint, because petitioner did not sufficiently plead reliance on respondents' deceptive conduct. Petitioner does not allege that it was even aware of the transactions that respondents executed with Charter; at most, petitioner relied on *Charter's* misstatements in purchasing Charter stock. Petitioner does not dispute that Charter independently decided to make the misrepresentations in its financial statements, and does not contend that respondents drafted or otherwise created those misstatements. Accordingly, the causal connection between respondents' conduct and petitioner's stock transactions is simply too attenuated to satisfy the reliance requirement. That is particularly true because respondents' alleged conduct relates to only one aspect of Charter's fraudulent scheme, and has no connection with the publicly disseminated misstatements relating to numerous other, contemporaneous fraudulent acts in which Charter allegedly engaged. For similar reasons, petitioner has also failed sufficiently to allege the related element of loss causation.

C. Allowing liability for a primary violation under the circumstances presented here would constitute a sweeping expansion of the judicially inferred private right of action in Section 10(b) and Rule 10b-5, potentially exposing customers, vendors, and other actors far removed from the market to billions of dollars in liability when issuers of securities make misstatements to the market. It would be particularly inappropriate to allow private liability under these circumstances in light of Congress's rejection of a private right of action for aiding and abetting liability under Section 10(b) in the wake of *Central Bank* (and Congress's creation of much narrower private rights of action in other provisions of the securities

laws). Congress consciously struck a balance between exposure to aiding-and-abetting liability and complete immunity by empowering the Securities and Exchange Commission alone to pursue cases of aiding and abetting. Petitioner's proposed rule would upset that congressional choice and vastly expand liability in unpredictable ways. Such a radical expansion of liability is a task for Congress, not the courts.

ARGUMENT

THE COURT OF APPEALS CORRECTLY HELD THAT RESPONDENTS CANNOT BE HELD LIABLE IN A PRIVATE ACTION UNDER SECTION 10(b) AND RULE 10b-5

Section 10(b) of the Securities Exchange Act of 1934 (1934 Act) makes it unlawful for "any person" "directly or indirectly" to "use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission (SEC)] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 78j(b). The SEC's Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," to (a) "employ any device, scheme, or artifice to defraud"; (b) "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made * * * not misleading"; or (c) "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5. This Court has noted that the scope of Rule 10b-5 is "coextensive" with that of Section 10(b). *SEC* v. *Zandford*, 535 U.S. 813, 816 n.1 (2002). And for violations of Section 10(b) and Rule 10b-5, courts have inferred a private right of action that "resembles, but is not identical to, common-law tort actions for deceit and misrepresentation."

Dura Pharmaceuticals, Inc. v. *Broudo*, 544 U.S. 336, 341 (2005).

The question presented in this case is whether a person may be liable in a private action under Section 10(b) and Rule 10b-5(a) and (c) for engaging in a transaction with the issuer of a security on the ground that the transaction constituted "deceptive" conduct, when the plaintiff did not rely on that conduct but at most relied only on subsequent misstatements by the issuer concerning the transaction. Contrary to the view seemingly expressed by the court of appeals, Section 10(b)'s prohibition against deception is not limited to actual misstatements or omissions, but encompasses non-verbal deceptive conduct as well. For the reasons set forth below, however, the district court correctly dismissed the complaint for failure to allege that petitioner relied on respondents' deceptive conduct, and the judgment of the court of appeals should therefore be affirmed.

A. The Phrase "Deceptive Device Or Contrivance," As Used In Section 10(b), Encompasses Deceptive Conduct As Well As Misstatements (And Omissions By Parties With A Duty To Disclose)

The court of appeals categorically stated that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." Pet. App. 9a. The court of appeals thereby appeared to foreclose the possibility that non-verbal deceptive conduct—*i.e.*, deceptive conduct other than misstatements or omissions—could give rise to a violation of Section 10(b). The court erred in its analysis in that regard, because a defendant may employ a "deceptive

device or contrivance" within the meaning of Section 10(b) by engaging in non-verbal deceptive conduct.[5]

1. The text of Section 10(b) unambiguously reaches non-verbal deceptive conduct, in addition to misstatements and omissions. Section 10(b) renders it unlawful for "any person" "directly or indirectly" to "use or employ" "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities. 15 U.S.C. 78j(b). This Court has previously addressed the meaning of the critical terms "device" and "contrivance." In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the Court, quoting from a contemporaneous dictionary, defined "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and defined "contrivance" as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." *Id.* at 199 n.20 (second brackets in original) (quoting *Webster's New International Dictionary* 580, 713 (2d ed. 1934)). The breadth of those terms demonstrates that Section 10(b) reaches *all* conduct that is "deceptive" or "manipulative" (assuming that the other statutory requirements are satisfied), not merely *verbal* conduct (*i.e.*, misstatements or omissions). Consistent with that interpretation, the SEC, in promulgating Rule 10b-5, pro-

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[5] The court seemingly recognized that Section 10(b) reaches at least some non-verbal conduct: *viz.*, when the "scheme or contrivance" at issue is "manipulative," rather than "deceptive." See Pet. App. 9a (holding that Section 10(b) makes it unlawful for a defendant, *inter alia*, to "engage in manipulative securities trading *practices*") (emphasis added). The court was correct to recognize that "manipulative" conduct can be non-verbal, because the prototypical examples of "manipulative" conduct are such non-verbal actions as "wash sales, matched orders, or rigged prices." *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 476 (1977). As the court of appeals noted (Pet. App. 9a & n.2), however, "manipulative" has been viewed as a term of art denoting manipulation that operates on *markets*, see, *e.g.*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 199 & n.21 (1976), and it is therefore not at issue in this case.

scribed not only misstatements and omissions that render statements misleading (in Rule 10b-5(b)), but also "any device, scheme, or artifice to defraud" (in Rule 10b-5(a)) and "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" (in Rule 10b-5(c)). The latter subparts of the rule would be rendered largely superfluous if Section 10(b) were construed to cover only misstatements and omissions.[6]

The legislative history of the 1934 Act confirms that Section 10(b) was intended to reach all forms of "deceptive" or "manipulative" conduct. The Senate Report indicated that Section 10, together with other sections of the 1934 Act, was "aimed at those manipulative and deceptive *practices* which have been demonstrated to fulfill no useful function," without distinguishing between verbal and non-verbal conduct. S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934) (emphasis added). And the Senate Report noted that, while Section 10(a) regulates short sales and stop-loss orders, Section 10(b) "authorizes the [SEC] by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive *practices* which it finds detrimental to the interests of the investor," again without distinguishing between verbal and non-verbal conduct. *Id.* at 18 (emphasis added).

2. Nothing in the ordinary meaning of the word "deceptive" suggests that it limits the range of actionable "device[s] or contrivance[s]" to misstatements or omissions. To the contrary, contemporary dictionaries confirm that "deception" and

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[6] Similarly, Section 21D(f)(10)(A) of the 1934 Act (which was added by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 201, 109 Stat. 758), in defining the circumstances under which a person "knowingly commits a violation of the securities laws" (and thus can be subject to joint and several liability), distinguishes between "an action that is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading" and "an action that is based on any [other] conduct." 15 U.S.C. 78u-4(f)(10)(A).

"deceit" can arise from verbal and non-verbal conduct alike. See, *e.g.*, *Black's Law Dictionary* 529 (3d ed. 1933) (defining "deception" as, *inter alia*, "intentional misleading by falsehood spoken or acted"); *Bouvier's Law Dictionary* 276 (1928) (noting, in defining "deceit," that "[a] fraudulent misrepresentation or contrivance * * * need not be made in words").

This Court's cases likewise provide no support for the apparently contrary view of the court of appeals, which asserted that "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." Pet. App. 8a; see *id.* at 5a, 9a. The court of appeals relied primarily on a single sentence from *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1994). See Pet. App. 5a. In that sentence, the Court stated that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Central Bank*, 511 U.S. at 177; see *id.* at 191 (same).

When that statement is read in context, it is clear that the Court did not intend to exclude non-verbal deceptive conduct from the reach of Section 10(b). In the very next sentence (and throughout the rest of the opinion), the Court used generic language indicating that the statute covers deceptive conduct, without distinguishing between verbal or non-verbal conduct. See *Central Bank*, 511 U.S. at 177 (stating that "[t]he proscription [in Section 10(b)] does not include giving aid to a person who commits a manipulative or deceptive *act*") (emphasis added); see also, *e.g.*, *id.* at 166 ("deceptive act"); *id.* at 167 ("deceptive practice"); *id.* at 170 ("deceptive act"); *id.* at 173 ("deceptive acts"); *id.* at 178 ("acts that are * * * deceptive"); *id.* at 183 ("deceptive conduct"); *id.* at 191 ("deceptive act"). To the extent that the relevant sentence can be read to have excluded non-verbal deceptive conduct, therefore, any such exclusion appears to have been inadvertent and

without significance. Cf. *SEC* v. *Edwards*, 540 U.S. 389, 396 (2004) (stating that "we will not bind ourselves unnecessarily to passing dictum that would frustrate Congress' intent" under the securities laws).

The court of appeals also cited *United States* v. *O'Hagan*, 521 U.S. 642 (1997), and *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) (see Pet. App. 5a), but those cases do not speak to the definition of "deceptive device or contrivance." Instead, they involved collateral issues concerning the circumstances under which a defendant can be liable for engaging in deceptive conduct by means of an omission alone. See, *e.g.*, *O'Hagan*, 521 U.S. at 654 (stating that "[d]eception through nondisclosure is central to the theory of liability for which the Government seeks recognition"); *Affiliated Ute Citizens*, 406 U.S. at 153 (noting that the defendants had failed to "disclos[e] to [the plaintiffs] material facts that reasonably could have been expected to influence their decisions to sell").

In sum, "§ 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception," and "[n]ovel or atypical methods should not provide immunity from the securities laws." *Superintendent of Insurance* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) (citation omitted); cf. *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 477 (1977) (concluding that "Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices"). The court of appeals thus erred to the extent it excluded non-verbal deceptive conduct from the scope of Section 10(b).

3. Because the court of appeals apparently concluded that only a misstatement or omission can constitute a "deceptive device or contrivance" for purposes of Section 10(b), it did

not attempt to elaborate on the circumstances under which other conduct could be "deceptive." The plain language of Section 10(b) provides substantial guidance on that issue. The same dictionary on which this Court relied in *Ernst & Ernst* in defining the statutory terms "manipulative," "device," and "contrivance" defines "deceptive" as "[t]ending to deceive" or "having power to mislead." *Webster's New International Dictionary* 679 (2d ed. 1934); see *ibid.* (defining "deceive" as "[t]o cause to believe the false, or disbelieve the truth"). It naturally follows that the phrase "deceptive device or contrivance" comprises any conduct that is committed with the requisite mental state and is objectively likely to mislead an observer: *e.g.*, conduct that has the effect of conveying a false appearance of material fact concerning a transaction into which the person has entered. Cf. *United States* v. *Russo*, 74 F.3d 1383, 1391 (2d Cir.) (concluding that trading scheme that "create[d] a false impression" of demand for stock constituted a "manipulative * * * device or contrivance" for purposes of Section 10(b)), cert. denied, 519 U.S. 927 (1996).[7]

When measured against the correct standard, respondents' alleged conduct in this case constituted a "deceptive device or contrivance." The parties are alleged to have deliberately backdated the agreements for the price increases in the set-top boxes, so as to make it appear that the parties had

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[7] In order to satisfy the "deceptive device or contrivance" requirement, a plaintiff need only allege that the defendant engaged in conduct that was objectively likely to mislead *another person*. Insofar as unlawful conduct under Section 10(b) requires some nexus with an *investor*, that requirement is rooted not in the "deceptive device or contrivance" requirement, but rather in Section 10(b)'s separate "in connection with" requirement, and (with respect to private actions) in the reliance and loss-causation requirements. See, *e.g.*, *O'Hagan*, 521 U.S. at 656-657; see also pp. 17-26, *infra*. Respondents did not seek dismissal in the district court on the ground that the "in connection with" requirement was not satisfied, and neither of the courts below addressed that question.

entered into those agreements before the reciprocal advertising agreements. See Scientific-Atlanta Br. in Opp. App. 33-34. By entering into the backdated agreements, respondents conveyed a false appearance of material fact concerning the transactions into which they had entered: *i.e.*, because their conduct not only was likely to, but in fact did, mislead Charter's outside accountant, Arthur Andersen, into believing that the two sets of transactions were discrete. On those alleged facts, respondents' conduct could be found to constitute a "deceptive device or contrivance" under Section 10(b).[8]

B. Because Petitioner Failed Sufficiently To Allege Reliance, The Court Of Appeals Correctly Upheld The Dismissal Of Petitioner's Complaint

In order to state a claim against a defendant as a primary violator of Section 10(b), a plaintiff not only must allege that the defendant engaged in "deceptive" or "manipulative" conduct, but also must satisfy "*all* of the [other] requirements for primary liability"—regardless of whether the defendant is itself the issuer of the relevant security or is a "secondary actor" (such as respondents). *Central Bank*, 511 U.S. at 191. Specifically, the plaintiff must allege that the defendant acted with the requisite scienter, see *Ernst & Ernst*, 425 U.S. at 194 n.12, and engaged in the requisite conduct "in connection with" the purchase or sale of a security, see *Dura Pharmaceuticals*, 544 U.S. at 341. Those requirements are elements not only of private actions such as this one, but also of criminal prosecutions and civil enforcement actions for viola-

[8] Indeed, it is unclear why the backdating does not constitute a misstatement that would satisfy even the court of appeals' erroneously restrictive view of Section 10(b). To the extent that the court of appeals' test excludes even some material misstatements, it deviates even further from the proper scope of Section 10(b)'s prohibition on all deceptive conduct.

tions of Section 10(b) brought, respectively, by the Department of Justice and the SEC.

Critically for purposes of this case, however, in order to state a claim in a *private* action under Section 10(b) and Rule 10b-5, the plaintiff also must satisfy the requirements of reliance and loss causation. See *Dura Pharmaceuticals*, 544 U.S. at 341-342. Although petitioner sufficiently alleged that respondents had engaged in deceptive conduct for purposes of Section 10(b), petitioner did not sufficiently plead that it had relied on that conduct. The court of appeals' decision upholding the dismissal of petitioner's complaint should be affirmed on that basis.[9]

1. In *Basic Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988), this Court expressly held that reliance is an element of a private action under Section 10(b) and Rule 10b-5. In so holding, the Court recognized that "reliance is and long has been an element of common-law fraud," *ibid.* (citing Restatement (Second) of Torts § 525 (1977)), and explained that "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." *Ibid.*; see *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974) (reasoning that the element of reliance requires that the defendant's fraudulent conduct have "caused the

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[9] The district court accepted respondents' contention that the complaint failed to allege reliance, noting that petitioner "do[es] not assert that * * * [it] relied on any statement, omission or action made by either of [respondents]." Pet. App. 11a. Respondents renewed that contention on appeal. See Scientific-Atlanta C.A. Br. 25-28; Motorola C.A. Br. 15-16. While the court of appeals did not address the reliance issue in detail, it appears to have endorsed the district court's resolution of that issue. See, *e.g.*, Pet. App. 7a (quoting the district court's ruling on reliance); *id.* at 10a (noting that respondents "did not issue any misstatement *relied upon* by the investing public") (emphasis added). In its brief before this Court, petitioner does not contend that the Court should not address the reliance issue, but instead contends only that reliance was sufficiently pleaded. See Br. 37-40.

[plaintiff] to engage in the transaction in question"), cert. denied, 421 U.S. 976 (1975). In *Central Bank*, the Court confirmed that reliance was "[an] element critical for recovery under Rule 10b-5," and that, in order to recover in a private action under Section 10(b) and Rule 10b-5, "[a] plaintiff must show reliance on the *defendant's* misstatement or omission" (or other deceptive conduct). 511 U.S. at 180 (emphasis added). Indeed, the importance of strict adherence to the reliance requirement in private actions against secondary actors was a key basis for this Court's rejection of aiding and abetting liability. "Were we to allow the aiding and abetting action proposed in this case," the Court reasoned, "the defendant could be liable without any showing that the plaintiff *relied upon the aider and abettor's statements or actions.*" *Ibid.* (emphasis added).[10]

In this case, petitioner does not contend that it relied upon respondents' allegedly deceptive conduct (*i.e.*, the backdating of the contracts increasing the price of the set-top boxes) in engaging in the relevant transactions (*i.e.*, the purchase of Charter shares). In fact, petitioner does not contend that it (or the investing public) was even aware of the transactions that respondents executed with Charter. Instead, petitioner freely concedes that "[r]espondents did not themselves disseminate the false information to the securities market," Br. 38, and alleges only that the backdating of the contracts assisted *Charter* in mischaracterizing the payments from respondents as revenue (and thus in inflating its operating cash flow in its financial statements). See, *e.g.*, Scientific-Atlanta Br. in Opp. App. 33-34. Those allegations might rise to the

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[10] See Restatement (Second) of Torts § 537 (1977) (providing that "[t]he recipient of a fraudulent misrepresentation can recover against its maker for pecuniary loss resulting from it if, but only if, * * * he relies on the misrepresentation in acting or refraining from action, and * * * his reliance is justifiable").

level of aiding and abetting Charter's misstatements, but they fail to establish petitioner's reliance on respondents' misconduct.[11] Because petitioner (and other investors) at most relied only on Charter's misstatements, and not on respondents' apparently undisclosed deceptive conduct, petitioner has failed sufficiently to allege reliance for purposes of its claim against respondents. See *Central Bank*, 511 U.S. at 180.

Petitioner contends (Br. 38, 39) that reliance is nevertheless sufficiently alleged because, but for respondents' deceptive conduct, Charter could not have made the misstatements on which it (and other investors) allegedly relied in purchasing Charter stock. But alleging "but-for" causation is no substitute for alleging reliance on respondents' own conduct. "But-for" causation does not distinguish primary from secondary liability; alleged misconduct by secondary actors is frequently necessary to fraudulent schemes (as the facts of *Central Bank* illustrate), but that alone does not make those actors primarily liable. Petitioner does not dispute that Charter independently decided to make the misrepresentations in its financial statements; indeed, in its complaint, petitioner seemingly recognizes that Charter could have accounted for its transactions with respondents in a way that would have rendered its financial statements accurate. See Scientific-Atlanta Br. in Opp. App. 4; cf. Pet. Br. 38 (alleging only that Charter's misstatements "built upon" respondents' deceptive conduct). Conversely, Charter could have misrepresented its operating cash flow in other respects without engaging in these transactions. The critical point is that it was Charter's

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[11] As discussed above, reliance is not an element in an enforcement action brought by the government under Section 10(b). Accordingly, a defendant as to whom reliance cannot be shown may nonetheless be liable in such an action, either as a principal violator or as an aider and abettor, even though it would be at most an aider and abettor (and therefore not liable) in the context of a private action.

misrepresentation of its cash flow, not respondents' conduct, on which petitioner allegedly relied.

Petitioner, moreover, does not contend that respondents affirmatively induced Charter to make the misstatements or that respondents actually drafted, created, or otherwise made those misstatements themselves. As numerous courts of appeals have correctly held, a secondary actor cannot be held liable in a private securities action by virtue of a plaintiff's reliance on misstatements that were not "made" by the secondary actor. See, *e.g. Fidel* v. *Farley*, 392 F.3d 220, 235 (6th Cir. 2004) (holding that accounting firm could not be liable for failing to correct issuer's misleading financial statements because it "did not make a material misstatement or omission"); *Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1205-1207 (11th Cir. 2001) (holding that, notwithstanding "allegations of substantial assistance in the alleged fraud," "no statements attributable to [defendant] were ever made to [p]laintiffs; therefore, [p]laintiffs could not have relied on [defendant] in making their investment decisions"); *Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (noting that "[r]eliance only on representations made by others cannot itself form the basis of liability") (citation omitted; brackets in original), cert. denied, 525 U.S. 1104 (1999); *Shapiro* v. *Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) (stating that accountants "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors" in order to be liable) (citation omitted); *Anixter* v. *Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (same); see also SEC Br. at 17-18, *Klein* v. *Boyd*, No. 97-1143, 1998 WL 55245 (3d Cir. Feb. 12, 1998) <www.sec.gov/pdf/klein.pdf> (arguing that a person who "*creates* a misrepresentation * * * can be liable as a primary violator," but that

person who merely "knew of misrepresentations" but had not "created" them "would not be liable as a primary violator").[12]

This Court's decision in *Central Bank* is to the same effect. As the Court emphasized in that case, secondary actors may be held liable in a private action under Section 10(b), but only when, *inter alia*, reliance on *their* conduct has been demonstrated: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or *makes* a material misstatement (or omission) *on which a purchaser or seller relies* may be liable as a primary violator." 511 U.S. at 191 (emphases added). Words or actions by a secondary actor that facilitate an issuer's misstatement, but are not themselves communicated to investors, simply cannot give rise to reliance (and thus primary liability in a private action). That principle is at the heart of the distinction between primary liability and secondary liability of the kind rejected in *Central Bank*.

In this case, there is an additional reason to conclude that the complaint fails to satisfy the reliance requirement. While respondents' conduct allegedly related to Charter's statements inflating its operating cash flow by at least $17 million in the fourth quarter of 2000, petitioners allege that Charter also engaged in other, contemporaneous fraudulent acts to misrepresent its revenues and costs—thus raising the question whether the decision of petitioner (or any other investor) to purchase Charter stock, in reliance on Charter's rosy financial reports, could be connected even in an attenuated sense to respondents' conduct (which appears to have given rise

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[12] The courts in *Ziemba*, 256 F.3d at 1205, and *Wright*, 152 F.3d at 175, also held that misstatements made by a secondary actor must be *publicly attributed* to the secondary actor before liability can attach in a private action. There is no need to consider the correctness of that requirement in this case, because no misstatements made by respondents were disseminated to investors, either with or without attribution.

only to a fraction of the total overstatement in operating cash flow).

For example, the complaint alleges that Charter engaged in a variety of practices that materially overstated its operating cash flow in 2000 (the year in which respondents' transactions occurred) by $195 million, and its operating cash flow for 2001 by $292 million. See Scientific-Atlanta Br. in Opp. App. 5, 66. But respondents' conduct could account for no more than $17.53 million of the overstatement, or less than 10% of the total for 2000. The complaint also alleges that Charter materially inflated its subscriber growth rate and misstated its expenses. *Id.* at 3, 38-40. Thus, even if this Court were to adopt petitioner's erroneous effort to equate reliance with mere "but-for" causation, but see *Dura Pharmaceuticals*, 544 U.S. at 344 (endorsing "the need to prove proximate causation"), it is difficult to see how petitioner could satisfy such a requirement, because, taking the facts as alleged in the complaint as true, there is no basis for concluding that, but for respondents' conduct, petitioner would not have purchased Charter stock. Under any standard for reliance, therefore, petitioner's complaint is deficient. Where a cause of action for aiding and abetting exists, an aider and abettor may be held accountable for losses resulting from the scheme it aided, but a theory of primary liability must focus on the actions of the defendant on which the plaintiff allegedly relied.[13]

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[13] In *Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040 (2006), petition for cert. pending, No. 06-560 (filed Oct. 19, 2006), the Ninth Circuit held that the reliance requirement would be satisfied as long as "the introduction of misleading statements into the securities market was the intended end result of a scheme to misrepresent revenue." *Id.* at 1051. In amicus briefs in that case, the SEC took the position that "[t]he reliance requirement is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction." SEC Reply Br. at 12, *Simpson*, *supra* (No. 04-55665)

2. Just as petitioner has failed sufficiently to allege that it actually relied on defendants' conduct in purchasing Charter stock, so too has petitioner failed to show that it is entitled to a presumption of reliance.[14] This Court has recognized presumptions of reliance in only two contexts: first, when a defendant with a duty to disclose has made a material omission (and it would thus be impossible to show how the plaintiff would have acted if the omitted information had been disclosed), see *Affiliated Ute*, 406 U.S. at 153-154, and second, when a defendant commits "fraud on the market" by publicly making material misstatements concerning an efficiently traded security, see *Basic*, 485 U.S. at 241-247.

Petitioner suggests (Br. 38 & n.14; Scientific-Atlanta Br. in Opp. App. 72) that it can avail itself of the fraud-on-the-market presumption. Even assuming, however, that the fraud-on-the-market presumption would be available in an action *against Charter* for its misstatements concerning the transactions with respondents, such a presumption could not assist petitioner in establishing reliance with respect to its claim against respondents. By its very terms, the presump-

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(Feb. 7, 2005) <http://www.sec.gov/litigation/briefs/homestore_020405.pdf>. The SEC's briefs, however, were filed without the involvement of the Solicitor General, and the position on reliance that was expressed in those briefs does not reflect the views of the United States. For the reasons stated in text, that position, and the Ninth Circuit's holding on reliance in *Simpson*, are inconsistent with *Central Bank* (and with this Court's other cases concerning the reliance requirement).

[14] As a practical matter, without a presumption of reliance, petitioner would probably be unable to proceed with a class action, because the individualized issue of reliance would "overwhelm[]" any common issues (and thereby preclude class certification under Federal Rule of Civil Procedure 23(b)(3)). *Basic*, 485 U.S. at 242; see, *e.g.*, *Regents of the Univ. of Cal.* v. *Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 394 (5th Cir. 2007) (holding that, because no presumption of reliance was available in a case involving similar allegations against secondary actors, the district court erred by granting class certification), petition for cert. pending, No. 06-1341 (filed Mar. 5, 2007).

tion applies only to publicly disseminated misrepresentations: "Because most *publicly available* information is reflected in market price, an investor's reliance on any *public* material misrepresentations * * * may be presumed for purposes of a Rule 10b-5 action." *Basic*, 485 U.S. at 247 (emphases added). Petitioner's complaint does not identify any public statements or actions by respondents. Accordingly, petitioner cannot rely on the fraud-on-the-market theory to satisfy the reliance requirement here.

3. For many of the same reasons that the complaint does not satisfy the reliance (or transaction-causation) requirement, it also does not satisfy the related loss-causation requirement.[15] In order to show loss causation, a plaintiff must prove that the defendant's fraudulent conduct "proximately caused the plaintiff's economic loss." *Dura Pharmaceuticals*, 544 U.S. at 346; see 15 U.S.C. 78u-4(b)(4) (codifying loss-causation requirement). In its complaint, petitioner alleges only that it purchased stock during a specified class period. See Scientific-Atlanta Br. in Opp. App. 2, 7. Petitioner does not allege that *respondents'* conduct caused its loss; indeed, petitioner does not even specifically allege how (and when) it was revealed that Charter had misrepresented its operating cash flow as it related to the transactions with respondents, much less that petitioner (or other class members) still held its

[15] Although respondents appear to have raised the loss-causation issue in the district court (see Scientific-Atlanta Mot. to Dismiss 20), they did not separately raise the issue in the court of appeals, and that court did not address it. Because of the purely legal nature of that issue, however, which is conceptually linked to the reliance issue (in that both address aspects of causation), and in view of the need for clarity and certainty regarding the scope of the implied private right of action under Section 10(b), the Court may wish to exercise its discretion to address that alternative ground for affirmance. See, *e.g.*, *United States* v. *Nobles*, 422 U.S. 225, 240 n.15 (1975).

Charter stock at the time that the revelation occurred.[16] Petitioner, moreover, does not allege that any injury it suffered from a decline in Charter's share price was attributable to the revelation that Charter had misrepresented its cash flow as it related to the transactions with respondents, as opposed to revelations concerning the numerous other fraudulent acts in which Charter allegedly engaged. See *id.* at 6 (generically alleging that Charter's share price fell during and after the class period as a result of "[i]ncreasing skepticism regarding the accuracy of [Charter's] prior disclosures" and "the disclosure of [a] [g]rand [j]ury [i]nvestigation" into Charter's accounting practices); cf. *Greenberg* v. *Crossroads Sys., Inc.*, 364 F.3d 657, 665 (5th Cir. 2004) (requiring plaintiff to show that "there is a reasonable likelihood that the cause of the decline in price is due to the revelation of the truth and not the release of the unrelated negative information"). Petitioner's complaint thus fails sufficiently to allege loss causation, as well as reliance.

C. Allowing The Complaint In This Case To Proceed Would Dramatically Broaden The Inferred Right Of Action In Section 10(b) And Rule 10b-5

In the wake of this Court's decision in *Central Bank*, Congress considered, and rejected, a proposal to create an express private right of action for aiding and abetting under Section 10(b), and chose instead to authorize only the SEC to seek civil redress against aiders and abettors. See, *e.g.*, 15 U.S.C. 78t(e); S. Rep. No. 98, 104th Cong., 1st Sess. 19 (1995). Congress thus struck a careful and deliberate balance between open-ended secondary liability, on the one hand, and

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[16] The amended complaint alleges only that, on June 18, 2002, an analyst expressed the view that Charter "ha[d] a more aggressive capitalization policy" than other cable operators (and that Charter "ha[d] done some marketing deals with equipment vendors"). Scientific-Atlanta Br. in Opp. App. 63-64.

impunity for aiders and abettors, on the other. Allowing liability for a primary violation under the circumstances presented here would effectively circumvent that congressional judgment and would constitute a sweeping expansion of the judicially inferred private right of action in Section 10(b) and Rule 10b-5.

1. This Court first recognized the existence of an inferred private right of action under Section 10(b) and Rule 10b-5 in *Bankers Life*, 404 U.S. at 13 n.9, at a time when the Court took the view that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose" expressed by a statute. *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 433 (1964). Since that time, however, the Court has consistently warned against judicial inference of private rights of action not specifically authorized by Congress. See, *e.g.*, *Sosa* v. *Alvarez-Machain*, 542 U.S. 692, 727 (2004); *Correctional Servs. Corp.* v. *Malesko*, 534 U.S. 61, 67 & n.3 (2001); *Alexander* v. *Sandoval*, 532 U.S. 275, 287-288 (2001). The Court has also repeatedly warned against extending preexisting inferred rights of action to new contexts. See, *e.g.*, *Wilkie* v. *Robbins*, 127 S. Ct. 2588, 2604-2605 (2007); *Malesko*, 534 U.S. at 74; *Schweiker* v. *Chilicky*, 487 U.S. 412, 421 (1988).

It would greatly expand the inferred private right of action under Section 10(b) and Rule 10b-5 if "secondary actors" could be held primarily liable whenever they engage in allegedly deceptive conduct, even if investors do not rely on (and are not even aware of) that conduct. Such a rule would expose not only accountants and lawyers who advise issuers of securities, but also vendors (such as respondents) and other firms that simply do business with issuers, to potentially billions of dollars in liability when those issuers make misrepresentations to the market. Such a rule would thereby considerably widen the pool of deep-pocketed defendants that could be

sued for the misrepresentations of issuers, increasing the likelihood that the private right of action will be "employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law." *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007). Moreover, extending liability to vendors could have the effect of substantially expanding liability for foreign companies that trade with publicly listed companies. Likewise, creating new and unpredictable liability for closely regulated entities like banks could create particular problems and greatly complicate the task of regulators. And the expansion of liability would raise difficult questions concerning the apportionment of liability where, as here, the conduct of the secondary actor relates only to a small part of a broader fraudulent scheme. See, *e.g.*, 15 U.S.C. 78u-4(f)(3)(C) (providing that, in apportioning liability, the trier of fact should consider "the nature of the conduct of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs" and "the nature and extent of the causal relationship between the conduct of each such person and the damages incurred by the plaintiff or plaintiffs").[17]

Permitting secondary actors to be held liable under these circumstances would also be inconsistent with the much narrower private rights of action that Congress expressly created in other provisions of the securities laws. This Court has repeatedly looked to those express rights of action in defining the contours of the inferred right of action in Section 10(b) and Rule 10b-5. See, *e.g.*, *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350, 359-360 (1991). In construing those express rights of action, moreover, the Court has strictly defined the class of persons who can be held lia-

[17] Indeed, a rule that permitted secondary actors to be held liable would raise the specter of joint and several liability where such an actor was found to have "knowingly" violated the securities laws. See 15 U.S.C. 78u-4(f)(2)(A).

ble. For example, in *Pinter* v. *Dahl*, 486 U.S. 622 (1988), the Court rejected the proposition that Section 12(1) of the Securities Act of 1933, 15 U.S.C. 77*l*(1), which imposes liability on any person who "offers or sells" an unregistered security, reaches any person whose participation in the transaction was a "substantial factor" in the transaction's occurrence. *Pinter*, 486 U.S. at 649. Petitioner's proposed rule not only would be inconsistent with the Court's practice in construing *express* rights of action, but would threaten to swamp those rights of action by creating an all-encompassing inferred right of action under Section 10(b) and Rule 10b-5. See, *e.g.*, 15 U.S.C. 77b(a)(11), 78t(a) (imposing liability on secondary actors only to the extent that they "control" persons who violate the securities laws); 15 U.S.C. 78r(a) (imposing liability on parties that "cause to be made" a false statement in an SEC filing, where the plaintiff acted "in reliance upon such statement"); cf. *Central Bank*, 511 U.S. at 180 (noting that "it would be * * * anomalous to impute to Congress an intention in effect to expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action").

2. Moreover, at the same time that it refused to create an express *private* right of action for aiding and abetting under Section 10(b), Congress expressly authorized the SEC to pursue civil enforcement actions on a theory of aiding and abetting liability for violations of the 1934 Act. See 15 U.S.C. 78t(e). In such actions, a person may be liable as an aider and abettor if the person "knowingly provides substantial assistance" to a primary actor's violation of the securities laws. *Ibid.*; cf. *Central Bank*, 511 U.S. at 168 (listing elements of preexisting private action for aiding and abetting). The SEC therefore can take action not only against any party that itself engages in deceptive or manipulative conduct in violation of Section 10(b), but also against any party that knowingly facilitates *another* party's deceptive or manipulative conduct: *e.g.*,

when, as is alleged to have occurred here, a party enters into a deceptive transaction in the knowledge that the other party intends to make misrepresentations concerning that transaction to its investors.

More fundamentally, Congress's unwillingness to recognize a private right of action for aiding and abetting suggests that this Court should be loath to create the functional equivalent of such a right of action itself. Cf. *Alexander*, 532 U.S. at 290 (noting that "[t]he express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others"). Such an action would upset the deliberate balance struck by Congress. Insofar as petitioner and its amici advance various policy arguments in favor of broad liability for secondary actors, there are ample policy arguments to the contrary (some of which apparently struck a chord when Congress last expressly addressed the issue). In any event, all of those policy arguments "are more appropriately addressed to Congress than to this Court." *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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No. 06-43

In The

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

BRIEF OF AARP, CONSUMER FEDERATION OF AMERICA, AND U.S. PIRG AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE**

AARP is a non-profit, non-partisan organization with more than 38 million members, dedicated to addressing the needs and interests of Americans aged 50 and older. As the largest membership organization representing the interests of older Americans, AARP has long been concerned about fraudulent practices in the securities industry. Older Americans are frequent targets of fraud because they often have significant assets and look for investment opportunities that will supplement Social Security and other sources of retirement income. As a result, AARP has made the need to combat securities fraud a high priority. It has regularly commented on legislative and regulatory proposals that address investment fraud, filed *amicus* briefs in cases involving the federal securities laws, and opposed legislative efforts to limit the remedies of defrauded investors.

AARP's advocacy and consumer education activities are informed by the many studies it has undertaken over the years to understand investors' knowledge, behaviors, and concerns. *See, e.g., AARP, Investor Perceptions and Preferences Toward Selected Stock Market Conditions and Practices: An AARP Survey of Stock Owners Ages 50 and Older* 21 (March 2004), *available at* http://www.assets.aarp.org/rgcenter/econ/investor.pdf. These studies show that individual investors often lack basic knowledge of how the securities markets operate and are unaware of the important features of their own investments. This problem

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* No party's counsel wrote this brief (in whole or in part), and no person other than *amici* and their counsel contributed monetarily to this brief's preparation or submission. The parties' letters consenting to the filing of this brief have been lodged with the Clerk of the Court.

is of particular concern given the entry of many first-time investors into the market and the responsibility for retirement investing that pensioners have had to assume as a result of the shift from defined benefit pension plans (under which employers bear the risk of loss) to defined contribution pension plans (under which plan participants bear the risk of loss). Integrity in the securities markets and the remediation of securities fraud is therefore more important today than ever.

The Consumer Federation of America (CFA) is a nonprofit association of 300 consumer groups, which in turn represent more than 50 million Americans. It advances the consumer interest through research, education, and advocacy. As increasing numbers of Americans have come to rely on the nation's financial markets to fund their retirement and invest their savings, CFA has made enhancing investor protections a top legislative and regulatory priority. CFA's policies in this area are based on a fundamental belief that investors are entitled to a marketplace that provides them with a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective remedies when they are defrauded. CFA has for nearly two decades been a leader in efforts to promote investor protection legislation and regulations, and to oppose efforts to weaken those protections, at both the state and federal levels. One of CFA's particular areas of concern has been the ability of investors to seek legal redress for their losses. Toward these ends, CFA has testified before Congress, participated in Securities and Exchange Commission (SEC) roundtables, submitted *amicus* briefs on a range investor-protection

issues, and consulted with members of Congress, SEC Commissioners, and state securities regulators.

U.S. PIRG is a national, non-profit advocacy group with over one million members around the country. Its mission is to protect the interests of consumers and ordinary citizens using the tools of investigative research, media reports, grassroots organizing, legislative and public policy advocacy, and litigation. Investor protection has been a long-standing area of concern to U.S. PIRG. It has appeared as an *amicus curiae* in support of investor rights in several of the important securities fraud cases that have come before the Court during recent years.

SUMMARY OF ARGUMENT

The answer the Court gives to the question presented in this case will have significant consequences for victims of major corporate frauds of the sort that brought down Enron, WorldCom, and other companies during the last decade. Recent history shows that investors harmed by these frauds all too often go uncompensated for their losses when the accountants, bankers, lawyers, and others who are not affiliated with the corporate issuer but who actively scheme with the issuer to defraud investors – *amici* call them "outside actors" here for ease of reference – are not held to account for their violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). Outside actors are often the only culpable defendants with assets sufficient to satisfy a judgment or fund a settlement that secures any real measure of relief for defrauded investors. Of course, the Court should not fashion a § 10(b) jurisprudence around an indiscriminate search for deep

pockets. But neither should it lose sight of the consequences that would result if it were to adopt the Court of Appeals' unduly restrictive interpretation of § 10(b).

ARGUMENT

Investors in Major Securities Fraud Cases Will Often Be Denied a Remedy for Their Losses When Outside Actors Are Not Held Liable for Violating § 10(b) of the Exchange Act

This past decade has seen corporate fraud on an unprecedented scale. *See, e.g., In re Enron Corp. Sec., Derivative, & ERISA Litig.*, 235 F. Supp. 2d 549, 565, 593, 687 (S.D. Tex. 2002); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 302 (2004) [hereinafter "*Gatekeeper Failure*"]; Geoffrey P. Miller, *Catastrophic Financial Failures: Enron and More*, 89 Cornell L. Rev. 423, 423-24 (2004); Robert W. Hamilton, *The Crisis in Corporate Governance*, 40 Hous. L. Rev. 1, 1-33 (2003); David Wessel, *What's Wrong – Venal Sins: Why the Bad Guys of the Boardroom Emerged En Masse*, Wall St. J., June 20, 2002, at A-1. The costs of recent frauds to shareholders – many of them individual investors and pension funds – have been enormous. Investor losses in many individual § 10(b) cases have run into the billions of dollars. The Enron fraud alone resulted in claimed damages totaling $40 billion. *See, e.g., Regents of the Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 379 (5th Cir. 2007).

Few, if any, of the major corporate frauds of the last decade have been perpetrated by corporate securities

issuers (including their officers, directors, managers, and other insiders) acting alone. Outside actors have played significant roles in nearly every one – in some instances by making false statements calculated to deceive investors about the issuer's financial condition and in others by participating in deceptive financial transactions calculated to achieve the same result.[1]

If the Exchange Act is to serve as the "indispensable tool with which defrauded investors can recover their losses" that Congress intended, Conference Report on Securities Litigation Reform, H.R. Conf. Rpt. 104-369, at 31, 1995 U.S.C.C.A.N. at 730 (1995); *see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510 (2006), then outside actors must be held accountable

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[1] We anticipate that the plaintiffs in the Enron securities fraud case (and perhaps others) will appear as an *amicus curiae* in this case and detail the fraudulent misrepresentations that Enron's banks made to the investing public through their financial transactions with Enron. *See, e.g., In re Enron*: 235 F. Supp. 2d at 637-57, 695-704; Pet. Writ Cert., *Regents of the Univ. of California v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 06-1341. Enron, though, is not the only example of a notorious fraud case that arose in large part from the conduct of outside actors. Other examples include the frauds involving *Global Crossing*, *see In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335-37 (S.D.N.Y. 2004), and Lincoln Savings & Loan, *see, e.g., In re: Am. Cont'l Corp./Lincoln Sav. and Local Sec. Litig.*, 140 F.R.D. 425, 428 (D. Ariz. 1992).

Amici also anticipate that petitioner and other *amici* will point out that outside actors are hardly blameless for many of recent history's securities frauds. Some distinguished commentators – not all of them sympathetic to the securities plaintiffs' bar – have assigned much of the blame for these frauds to the accountants, bankers, lawyers, and other professionals (called "gatekeepers" by one commentator) on whom the investing public relies to ensure that our markets operate with integrity. *See, e.g.*, Coffee, *Gatekeeper Failure*, *supra*; John C. Coffee, Jr., *Guarding the Gatekeepers*, N.Y. Times, May 13, 2002, at A-2.

when (as alleged in this case) their conduct violates the explicit language of § 10(b) and its companion SEC rule, Rule 10b-5, 17 C.F.R. § 240.10b-5. The victims of several of the most notorious recent frauds have achieved a substantial measure of recovery (though in each case far from all of their losses) only because courts allowed them to proceed against culpable outside actors. *See, e.g.*, *In re WorldCom, Inc. Sec. Litig.*, 388 F. Supp. 2d 319, 322, 325 (S.D.N.Y. 2005); Pet. Writ. Cert., *Regents of the Univ. of Calif. v. Merrill Lynch Pierce Fenner & Smith, Inc.* (No. 06-1341), at ii, 3 (Enron).

As *amici* establish below, none of the other usual sources of recovery in securities fraud cases – i.e., the corporate issuer, the issuer's officers, directors, and other insiders, or the issuer's directors' and officers' (D&O) liability policies – can provide any meaningful relief for the victims of most major frauds.

I. Major Fraud Cases Often Involve Insolvent Stock Issuers from Which Defrauded Investors Cannot Obtain Any Recovery for Their Losses.

Nearly all of recent history's most notorious securities fraud cases – including those involving Enron, Equity Funding, Global Crossing, Lincoln Savings and Loan, Refco, Sunbeam, U.S. Financial, and WorldCom – involved securities issuers that were insolvent by the time (or soon after) the filing of a § 10(b) case. *See, e.g.*, *Hevesi v. Citigroup, Inc.*, 366 F.3d 70, 73 (2d Cir. 2004); Hamilton, *The Crisis in Corporate Governance, supra*, at 20-26. The result for investors defrauded by insolvent issuers is usually the same: The issuer files for bankruptcy, and the automatic stay provision of the bankruptcy code, 11 U.S.C.

§ 362(a), then shields the issuer from suit, leaving the defrauded shareholder with a usually-worthless (pre-petition) claim against the insolvent issuer that is not worth pursuing and is seldom pursued.[2] *See, e.g.*, *Hevesi*, 366 F.3d at 74 n.1 (noting that WorldCom's bankruptcy filing "prevent[ed] litigation against WorldCom from going forward").

As a result, only culpable stock issuer's officers and managers, directors, and outside actors remain viable defendants in these cases.[3] *See, e.g.*, *id.*; *see also, e.g.*, *In re Refco Sec. Litig.*, 05 Civ. 8626, 2007 U.S. Dist. LEXIS 31969, at *11 (S.D.N.Y. Apr. 30, 2007); *In re Global Crossing Sec. and ERISA Litig.*, 225 F.R.D. 436, 441 (S.D.N.Y. 2004); *In re: Am. Cont'l Corp./Lincoln Sav. and Loan Sec. Litig.*, 140 F.R.D. at 427; *In re Equity Funding Corp. of Am. Sec. Litig.*, 375 F. Supp. 1378, 1380 (1974). *See generally* Coffee, *Reforming the Securities Class Action*, *supra*, at 1551 n.64 (noting that "insiders and secondary participants [i.e., outside actors] are the only parties that can be sued once bankruptcy has been filed").

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[2] Criminal proceedings against individual defendants in civil cases may also result in stays. In the WorldCom securities litigation, for instance, the district court stayed all proceedings against the company's former CEO (Bernard Ebbers) pending the resolution of criminal proceedings against him. *See In re WorldCom Sec. Litig.*, 02 CV 3288, 2005 Dist. LEXIS 1805, at *5 n.1 (S.D.N.Y. Feb. 10, 2005); *see also In re WorldCom, Inc. Sec. & ERISA Litig.*, No. 02 Civ. 3288, 2002 U.S. Dist. LEXIS 23172 (S.D.N.Y. Dec. 5, 2002) (staying litigation against other executives).

[3] Securities class actions are actually seldom filed (against the stock issuer or anyone else) if the stock issuer declares bankruptcy. *See, e.g.*, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1551 n.64 (2006) [hereinafter "Reforming the Securities Class Action"].

II. Corporate Insiders Seldom Have Sufficient Assets to Compensate Defrauded Investors for Their Losses in Major Fraud Cases.

As for the issuer's officers, directors, managers, and other insiders,[4] their personal assets can usually cover only (at best) a small fraction of investor losses in any sizable fraud. *See, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1554-55. The damages in major securities fraud cases can and often do run into the billions of dollars. *See, e.g.*, *Regents of the Univ. of California*, 482 F.3d at 379; *In re Global Crossing*, 225 F.R.D. at 460; *see also* Coffee, *Reforming the Securities Class Action*, *supra*, at 1555 (cataloguing settlement amounts in major securities fraud cases). Few, if any, corporate officers and directors have the kind of assets needed to make their victims whole. *See, e.g.*, *In re Global Crossing*, 225 F.R.D. at 460 (noting that settlement was being funded by individuals "whose assets individually and collectively do not come close to the tens of billions of dollars of liability claimed"). The combined assets of Enron's CEO (Jeffrey Skilling) and board chairman (Kenneth Lay) just after their convictions, for example, represented less than one

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[4] While outside directors are often sued, they usually do not face liability or contribute personally to settlements. *See* Bernard Black, Brian Cheffins, & Michael Klausner, *Outside Directors Liability*, 58 Stan. L. Rev. 1055, 1063-64 (2006); Joann S. Lublin, Theo Francis, & Jonathan Weil, *Directors Are Getting the Jitters – Recent Settlements Tapping Executive' Personal Assets Put Boardroom on Edge*, Wall St. J., Jan. 13, 2005, at B-1. A recent study found only 13 securities fraud cases before Enron and WorldCom in which outside directors made out-of-pocket payments to fund a settlement. *See id.* As for Enron's and WorldCom's outside directors, they contributed only $18 million and $13 million out of pocket, respectively, to the Enron and WorldCom settlements. *See* Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1057.

percent of the total damages suffered by Enron's defrauded investors. *See, e.g.*, John R. Emshwiller & Gary McWilliams, *What's Left of Lay and Skilling Wealth Is at Risk*, Wall St. J., May 27, 2006, at A-2; *see also, e.g.*, *In re WorldCom*, 2005 Dist. LEXIS 1805, at *5 (noting that the outside directors' $18 million contribution to the settlement in WorldCom represented 20 percent of the directors' total combined assets). It is telling that the largest payout in a securities fraud settlement by a corporate insider (Gary Winnick, the chairman of Global Crossing) was $55 million in a suit involving claimed damages in the billions of dollars. *See, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1552.

Even the limited assets of insiders, though, are not always available for recovery by defrauded investors. Sometimes they are seized in connection with, or exhausted on defense costs in, the related criminal proceedings that often accompany civil securities fraud cases. *See, e.g.*, Emshwiller & McWilliams, *What's Left of Lay and Skilling Wealth Is At Risk*, *supra*; John R. Emshwiller, *Enron Trial Highlights Issue of Plea Bargain*, Wall St. J., Oct. 11, 2004, at C-1.

III. D&O Policies Usually Provide No or Inadequate Coverage in Major Fraud Cases.

While D&O policies fund much of the plaintiffs' and class members' recovery in garden-variety fraud cases, *see, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1551, they do the victims of major frauds involving

insolvent stock issuers little good in most cases. There are four main reasons why:[5]

First, nearly all D&O policies exclude from coverage the kind of fraud that normally gives rise to § 10(b) liability. Once the defendant is found liable for securities fraud, the insurer may decline coverage. *See, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1086; Coffee, *Reforming the Securities Class Action, supra*, at 1574. Matters are only likely to get worse in the future. Insurers have begun to cut back on coverage, *see, e.g.*, Jonathan D. Glater & Joseph B. Treaster, *Insurers Scale Back Corporate Liability Policies*, N.Y. Times, Sept. 7, 2002, at C-1, and some insurers have even refused to issue policies altogether in perceived "high-risk" industries, *see, e.g.*, Hamilton, *The Crisis in Corporate Governance*, *supra*, at 38.

Second, a D&O policy may be impaired. The insurer of an insolvent company embroiled in allegations of fraud will often seek to rescind the company's D&O policy on the claimed ground that the company made misrepresentations (deliberately or negligently) when it purchased the policy. *See, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1551, 1556, 1578-79; Michael H. Diamond, *D&O Insurance: Pitfalls in a New World*, Nat'l L. J., Aug. 26-Sept. 2, 2002, at A-22. Oftentimes the misrepresentations that

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[5] *Amici* exclude from consideration here fiduciary and other insurance policies that may cover pension plan losses arising from the investment of pension plan assets in the security issuer's stock. Recovery of those losses are not sought in § 10(b) actions but instead in breach-of-fiduciary actions brought under the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1001 *et seq.* ERISA suits, of course, benefit only pension plan participants, not stock purchasers generally.

forms the basis of the rescission reside in the very SEC filing that forms the basis of the securities fraud claim. *See, e.g., In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455, 462 (S.D.N.Y. 2005). Disputes over rescission have become common. *See, e.g., id.* at 455, 456-66; *Two Insurers Seek Right to Challenge Claims From Enron Lawsuits*, Wall St. J., Feb. 22, 2002, at B4. Insurers have responded by writing policies that expand their rights of rescission in cases of alleged fraud. *See, e.g.*, Theo Francis, *Directors' Armor: Adelphia Ruling Shows Legal Bills Must Be Covered*, Wall St. J., Mar. 24, 2004, at C-5.

Third, even an unimpaired D&O policy will cover only a modest fraction of the total damages. Losses in major securities fraud cases dwarf coverage limits. *See, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1119, 1125; Coffee, *Reforming the Securities Class Action*, *supra*, at 1555-56, 1577-78. Most large U.S. companies carry D&O policies with coverage limits of between $100 and $200 million, *see, e.g.*, Coffee, *Reforming the Securities Class Action*, *supra*, at 1577-78, and not even the largest corporations can afford to insure against losses on the order of those suffered by the investors of issuers like WorldCom, *see id.* at 1556. (Few insurers even sell policies with coverage exceeding $300 million. *See id.* at 1578.) All of Enron's D&O policies together provided only $350 million in coverage. *See, e.g., Two Insurers Seek Right to Challenge Claims from Enron Lawsuits*, Wall St. J., Feb. 22, 2002, at B-4. WorldCom, whose fraud likewise caused billions of dollars in investors losses, had only $100 million in D&O coverage. *See In re WorldCom,* 354 F. Supp. 2d at 460.

Fourth, defense costs in securities fraud cases often quickly exhaust whatever limited D&O coverage may

exist. *See, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1125. Securities fraud cases are complex, protracted, and expensive to defend. The longer a suit's life, the less insurance money there will be to fund a settlement or satisfy a judgment. For example, by the time of the (partial) settlement in the Enron securities fraud case, $150 million of Enron's $350 million (combined) policies had been spent on defense costs, *see, e.g.*, Black, Cheffins, & Klausner, *Outside Directors Liability*, *supra*, at 1125; in the WorldCom securities case, $15 million of a $100 million policy had been spent on defense costs, *id.* at 1119; and in the Global Crossing securities fraud case, to give a last example, $40 million of a $50 million policy had been spent on defense costs. *See Global Crossing*, 225 F.R.D. at 443, 445, 460.

* * *

Several of the lower courts (including the Court of Appeals in this case) that have interpreted § 10(b) to exclude so-called "scheme liability" from its reach have justified their interpretation by indulging dubious policy considerations of one sort or another. *See, e.g.*, *Credit Suisse First Boston*, 482 F.3d at 391-92; *In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992-93 (8th Cir. 2006). There are, however, important countervailing policy considerations that support the plain-meaning reading of § 10(b) (and its companion SEC regulation, Rule 10b-5) urged by the petitioner in this case. None of them is more important, to be sure, than the ability of defrauded investors to recover their losses in the sort of major fraud cases addressed in this brief.

CONCLUSION

The Court should reverse the judgment of the Court of Appeals.

Respectfully submitted,

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In The

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Petitioner,

v.

SCIENTIFIC ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

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INTEREST OF *AMICI CURIAE*[1]

Charles W. Adams is a professor of law at The University of Tulsa College of Law, where he has taught courses in intellectual property law and civil procedure. William von Glahn is an adjunct professor of law who teaches courses in securities regulation and corporate finance. Aside from wishing to assist the Court, our interests in this case are entirely academic.

SUMMARY OF ARGUMENT

This brief supports the Petitioner's position that this Court should recognize claims under § 10(b) of the Securities Exchange Act of 1934 and Rule 10(b)(5) against persons who do not themselves make misrepresentations to the public. In contrast to the arguments that the Petitioner made in its Petition for Certiorari to the effect that the Respondents should be potentially liable as primary violators of § 10(b) and Rule 10(b)(5), this brief urges this Court to recognize that they are secondarily liable, if it can be shown that the Respondents participated in a deceptive practice by giving substantial assistance to a primary violator of § 10(b) and Rule 10(b)(5), and they had actual knowledge that the primary violator was engaging in or intended to engage in fraudulent conduct when they gave assistance to the primary violator.

In *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994), this Court broadly declared that a private plaintiff

[1] Letters from the attorneys for all parties consenting to the filing of this *amici curiae* brief have been filed with the Clerk.

We are not representing any clients, and the views expressed in this brief are our own. We have no monetary interest in this case.

may not maintain an action for aiding and abetting under § 10(b) against persons who did not engage in the manipulative or deceptive practice. However, it held open the possibility that secondary actors could be liable if all the elements for a primary violation under Rule 10b-5 were satisfied. Since that decision, plaintiffs have struggled to fit their cases into primary liability to avoid the perceived limitation of *Central Bank*. Moreover, secondary actors who knowingly assisted others in perpetrating securities fraud have escaped liability.

Stare decisis requires this Court to follow its decision in *Central Bank* to bar aiding and abetting claims against secondary actors who engage in reckless conduct, but this Court should not extend *Central Bank* to bar secondary liability for securities violations against persons who either induce other persons to violate securities laws or aid and abet other persons to violate securities laws with actual knowledge of the violations. A recognition that § 10(b) authorizes secondary liability for securities violations is consistent with Congressional intent, because it is not reasonable that Congress would have intended that secondary actors who participate in deceptive practices by knowingly assisting others to perpetrate securities fraud should not be liable for the consequences of the securities fraud. The "directly or indirectly" language in § 10(b) supports recognition of secondary liability. This Court's unanimous decision in *MGM Studios, Inc. v. Grokster*, 545 U.S. 913 (2005), finding secondary liability under the copyright law based on common law principles also supports recognition of secondary liability for violations of § 10(b).

ARGUMENT

I. Common Law Principles of Liability for the Conduct of Other Persons

In the classic novel, OLIVER TWIST, Charles Dickens created the villain, Fagin, a reprehensible character who recruited children, including the Artful Dodger and Oliver, for his school for pickpockets. In return for their food and shelter, the children turned over to Fagin the jewelry and other items they stole from the citizenry of nineteenth century London. Certainly Fagin was more blameworthy than the children. After all, he was the adult. Moreover, he was the one who instigated their larcenous activities by teaching them to be pickpockets. Yet Fagin was merely a secondary actor, because he himself did not commit any thefts directly. Rather he induced the children at his school to steal for his benefit.

While there are probably no schools for pickpockets like in Dickens' novel, there are other characters that remind us of Fagin in modern society. This Court dealt with two of them recently in its decision in *MGM Studios, Inc. v. Grokster*, 545 U.S. 913 (2005), where it unanimously ruled that the distributors of peer-to-peer file sharing computer networking software were secondarily liable for the copyright infringement by millions of users of the software. There are also Fagin-like characters in the securities industry.

The common law of torts has developed principles governing the liability of persons for the tortious conduct of other persons that are summarized in the RESTATEMENT (SECOND) OF TORTS §§ 876 and 877. Paragraph (b) of § 876 provides as follows for liability for aiders and abettors:

> For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he . . . (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . .

Paragraph (a) of § 877 provides as follows for inducing tortious conduct:

> For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) orders or induces the conduct, if he knows or should know of circumstances that would make the conduct tortious if it were his own . . .

These principles are generally straightforward for trial judges and juries to apply. For example, a manufacturer of ammonium nitrate would not be liable as an aider and abettor under § 876(b) to persons who were injured when the ammonium nitrate exploded, unless the manufacturer knew that the purchaser intended to use the ammonium nitrate as an explosive. *Cf. Gaines-Tabb v. ICI Explosives, USA, Inc.*, 160 F.3d 613 (10th Cir. 1998) (fertilizer manufacturer was not liable for Oklahoma City bombing). On the other hand, a co-conspirator who supplied ammonium nitrate to a terrorist with knowledge that the terrorist intended to use the ammonium nitrate as a weapon of mass destruction would be liable as an aider and abettor for the injuries that the terrorist caused with the ammonium nitrate. *Cf. United States v. Nichols*, 169 F.3d 1255 (10th Cir. 1999) (affirming conviction of Terry Nichols for conspiring to use weapon of mass destruction and involuntary manslaughter). Similarly, a gun manufacturer would not be liable for injuries caused by its products, *cf.*

Hamilton v. Beretta U.S.A. Corp., 750 N.E.2d 1055 (N.Y. 2001) (gun manufacturer did not owe a duty of reasonable care in the marketing and distribution of handguns to persons killed by its handguns), but a person who supplies a gun to an accomplice knowing that the accomplice intends to use the gun to commit a tort would be liable as an aider and abettor, *cf. Halberstam v. Welch*, 705 F.2d 472 (D.C. Cir. 1983) (live-in companion of burglar was liable under § 876(b) for wrongful death of victim killed by the burglar because she provided substantial assistance to the burglar and had actual knowledge of the burglar's illegal activity).

Fagin is a paradigm for inducing tortious conduct under § 877(a), because he did more than provide substantial assistance to the pickpockets; he instigated their larcenous activities. The defendants in *Grokster* are also examples of inducers of tortious conduct. 545 U.S. at 937-38.

Interestingly, the requisite mental states differ for liability for aiding and abetting under § 876(b) and for inducing tortious conduct under § 877(a). Actual knowledge of the tortious conduct is required for aider and abettor liability under § 876(b), but either actual or constructive knowledge suffices for inducing tortious conduct. Actual knowledge is crucial to an aider and abettor's liability, because it provides a basis for the aider and abettor's culpability and prevents persons who unwittingly provide substantial assistance to a tortfeasor from being held liable for the consequences of the tortfeasor's conduct. In contrast, an inducer of tortious conduct is liable under § 877(a) if the inducer either knew or reasonably should have known that the other person's conduct was tortious. By instigating tortious conduct by another person an

inducer becomes liable not only for what the inducer knew would happen but also what the inducer reasonably should have known.

The next section of this brief discusses the application of the common law principles of aider and abetting liability and inducing tort liability in intellectual property law.

II. Application of Common Law Principles in Intellectual Property Law

When Congress passes legislation, it acts against a background of traditional common law rules, and therefore, federal legislation should generally incorporate those rules. The same principle should apply where this Court has implied a private right of action. This principle is exemplified by *Meyer v. Holley*, 537 U.S. 280 (2003), where this Court unanimously held that "when Congress creates a tort action, it legislates against a legal background of ordinary tort-related vicarious liability rules and consequently intends its legislation to incorporate those rules." *Id.* at 285. The tort law principles of secondary liability have been applied for many years in the intellectual property areas of patent, copyright, and trademark law.

Secondary liability for patent infringement had its genesis in *Wallace v. Holmes*, 29 F. Cas. 74 (C.C.D. Conn. 1871), a case which provides a good illustration of the need for secondary liability in patent law. *Wallace* was concerned with a patent for a lamp consisting of a burner and a glass chimney that was attached to the burner. The defendants manufactured and sold burners that were substantially the same as the burners described in the patent, but the defendants did not directly infringe

the patent, because they did not sell chimneys with the burners. Instead, the purchasers of the burners directly infringed the patent when they attached chimneys that they had purchased separately to the defendant's burners. Although there was then no statutory basis for secondary liability for patent infringement, the *Wallace* court held that the defendants were liable because they acted in actual concert with the makers of the chimneys to cause infringement of the patent. Over the years after the *Wallace* case, the doctrines of contributory infringement and inducing infringement of patents developed until they were codified as paragraphs (b) and (c) of 35 U.S.C. § 271 by the Patent Act of 1952. The Senate Report accompanying the adoption of § 271 confirms the common law origins of contributory infringement in patent law:

> Paragraphs (b), (c), and (d) relate to the subject referred to as contributory infringement. The doctrine of contributory infringement has been part of our law for about 80 years. . . . Considerable doubt and confusion as to the scope of contributory infringement has resulted from a number of decisions of the courts in recent years. The purpose of this section is to codify in statutory form principles of contributory infringement and at the same time eliminate this doubt and confusion.

S. Rep. No. 82-1979, at 8 (1952), *reprinted in* 1952 U.S.C.C.A.N. 2394, 2402. For further discussion of the historical background of contributory infringement and the enactment of 35 U.S.C. § 271, see 5 DONALD S. CHISUM, CHISUM ON PATENTS, § 17.02 [1]-[6] (2004); Charles W. Adams, *A Brief History of Indirect Liability for Patent Infringement*, 22 SANTA CLARA COMPUTER & HIGH TECH. L.J. 369 (2006); Giles S. Rich, *Infringement Under Section*

271 of the Patent Act of 1952, 21 GEO. WASH. L. REV. 521 (1953).

This Court recently recognized secondary liability in copyright law in *MGM Studios, Inc. v. Grokster*, 545 U.S. 913 (2005), holding that "one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties." *Id.* at 919. This Court explicitly noted in *Grokster* that secondary liability in copyright was based on the common law: "Although '[t]he Copyright Act does not expressly render anyone liable for infringement committed by another,' these doctrines of secondary liability emerged from common law principles and are well established in the law. . . ." [Citations omitted]. This Court had previously decided in *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417 (1984), that Sony was not secondarily liable for copyright infringement by purchasers of the VCR's Sony manufactured on account of its "constructive knowledge of the fact that its customers may use that equipment to make unauthorized copies of copyrighted material," *id.* at 439, because the VCR's were capable of substantial noninfringing uses, *id.* at 442. The Court of Appeals in *Grokster* ruled that the *Sony* decision precluded secondary liability of the *Grokster* defendants because like Sony's VCR's, the peer-to-peer file sharing software the *Grokster* defendants distributed had substantial noninfringing uses. 545 U.S. at 934. This Court reversed on the ground that *Sony* "was never meant to foreclose rules of fault-based liability derived from the common law." *Id.* at 934-35. It pointed out that:

> [A]t common law a copyright or patent defendant who 'not only expected but invoked [infringing

> use] by advertisement' was liable for infringement 'on principles recognized in every part of the law.' [Citations omitted].
>
> The rule on inducement of infringement as developed in the early cases is not different today.

Id. at 935-36. This Court continued with an analysis of the evidence presented of the defendants' intent to induce infringement, which included their positioning themselves to satisfy the demand for copyright infringement by former Napster users, their failure to develop filtering tools to avoid infringement by their users, and their business model of selling advertising that benefited from high volumes of infringing activity by their users. *Id.* at 939-40. This Court concluded: "The unlawful objective is unmistakable." *Id.* at 940.

While this Court did not refer to RESTATEMENT (SECOND) OF TORTS §§ 876, 877 in either the *Sony* or *Grokster* decisions, its conclusions are completely in line with them. Sony could not be liable under § 876(b) as an aider and abettor on the basis of its having constructive knowledge of copyright infringement by its customers. Instead, actual knowledge that particular customers would use the VCR's to infringe was required as long as the VCR's were capable of substantial noninfringing uses. If the VCR's had no substantial noninfringing uses, however, Sony's actual knowledge of infringing uses might reasonably have been inferred and Sony might have been held liable as an aider and abettor under RESTATEMENT (SECOND) OF TORTS § 876(b). In contrast, the *Grokster* defendants could be liable under § 877(a) based on their intent to induce the users of their software to engage in copyright infringement.

A comparison of the results in *Sony* and *Grokster* shows that it is feasible for courts to decide issues of secondary liability on the basis of the culpability of the parties. Despite the complexity of the technology involved in the cases, it was apparent that the *Grokster* defendants were modern-day Fagins, while Sony was not.

Finally, this Court has recognized secondary liability for trademark infringement despite the lack of statutory authority for it. In *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.*, 456 U.S. 844 (1982), this Court held:

> [L]iability for trademark infringement can extend beyond those who actually mislabel goods with the mark of another. . . . Thus, if a manufacturer or distributor intentionally induces another to infringe a trademark, or if it continues to supply its product to one whom it knows or has reason to know is engaging in trademark infringement, the manufacturer or distributor is contributorially responsible for any harm done as a result of the deceit.

Id. at 930-31.

Since secondary liability has been imposed in patent, copyright, and trademark law on the basis of common law tort principles in the absence of express statutory authority, surely these common law principles should be recognized in securities law, because all of these statutory schemes were enacted against a common law legal background. The next section of this brief discusses how the common law principles from the RESTATEMENT (SECOND) OF TORTS §§ 876, 877 should be applied in securities law.

III. Application of Common Law Principles to Securities Law

Section 10(b) makes it "unlawful for any person, *directly or indirectly*," (emphasis added) to use any manipulative or deceptive device in connection with the sale of registered securities. The use of the "directly or indirectly" language signifies a Congressional intent to extend liability for § 10(b) violations beyond primary violators to Fagin-like characters who do not violate § 10(b) directly by making false statements themselves, but instead violate § 10(b) indirectly by either inducing or aiding and abetting others to commit § 10(b) violations. As the preceding section of this brief pointed out, this Court has consistently upheld the use of secondary liability in patent (before its codification in 1952), copyright, and trademark cases for many years, even though there was no provision in the statutes in these areas for secondary liability. The presence of the "directly or indirectly" language in § 10(b) provides even more reason to recognize secondary liability for § 10(b) violations under the common law principles set out in the RESTATEMENT (SECOND) OF TORTS §§ 876, 877.

This Court stated broadly in *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994) that: "Because the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)." This broad language was not necessary for the decision in *Central Bank*, which involved an aiding and abetting claim against a party who was alleged to have been reckless, but who neither had actual knowledge of the § 10(b) violation nor provided substantial assistance to the primary violator. Consequently, this Court's statement should not foreclose consideration of whether aiding and abetting for a § 10(b)

violation should be recognized for the different circumstances in this case. Last year this Court held in *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), that "we are not bound to follow our dicta in a prior case in which the point now at issue was not fully debated." *Id.* at 363. Quoting Chief Justice Marshall from *Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264 (1821), this Court reasoned: "It is a maxim not to be disregarded, that general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used. If they go beyond the case, they may be respected, but ought not to control the judgment in a subsequent suit when the very point is presented for decision." *Id.* at 399. The facts in *Central Bank* did not present the issues that are involved in this case, and therefore, *Central Bank* is not controlling.

Central Bank was an indenture trustee who was responsible for seeing that the covenants in two public bond issues, one in 1986 and the other in 1988, were satisfied. Among the bond covenants was a requirement for the land securing the bonds to be worth at least 160% of the bonds' outstanding principal and interest and for the property developer to provide Central Bank with an annual report showing that the 160% test had been met. In early 1988, the property developer sent Central Bank an updated appraisal for the land securing both the 1986 bonds and the bonds still to be issued in 1988. While the 1988 appraisal showed land values to be almost unchanged from the 1986 appraisal, Central Bank also received a letter from the senior underwriter that expressed concern that the 160% test was no longer satisfied. Unfortunately, by the time Central Bank had retained an outside appraiser and the outside appraiser had conducted

an independent review of the land values, the 1988 bonds had been issued and the bonds were in default.

Purchasers of the 1988 bonds then sued various defendants under § 10(b), including Central Bank, claiming that Central Bank was secondarily liable for aiding and abetting the fraud in connection with the sale of the bonds. The trial court granted summary judgment for Central Bank, but the Tenth Circuit reversed on the grounds that there were material issues of fact concerning 1) whether Central Bank provided substantial assistance to the fraud by delaying the independent review of the appraisal until after the default on the bonds, and 2) whether Central Bank was reckless, because it knew that the sale of the bonds was imminent and that purchasers were relying on the 1988 appraisal to evaluate the collateral for the bonds. 511 U.S. at 168-69.

This Court reversed the Tenth Circuit, ruling that summary judgment for Central Bank was proper on the expansive ground that aiding and abetting actions are not allowed under § 10(b). It was not necessary for this Court to have gone this far, however, because this Court should have decided the case on a narrower ground – that the requirements for aiding and abetting liability in RESTATEMENT (SECOND) OF TORTS § 876(b) were not satisfied under the facts in *Central Bank*.

The elements required for aider and abettor liability under § 876(b) are that Central Bank must have provided substantial assistance to the § 10(b) violation and that Central Bank must have had actual knowledge of the § 10(b) violation when it provided the substantial assistance to the primary violator. Central Bank may have been lazy, sloppy, and incompetent; it may have moved too

slowly and may not have been diligent; and it may have been negligent or even reckless. There was no evidence that Central Bank had actual knowledge of a 10(b) violation, however, since it was not shown that Central Bank knew that the property developer's appraisal was not correct, and therefore Central Bank could not have known that the sale of the bonds would be based on an inflated out of date appraisal. Moreover, there was no evidence that Central Bank provided substantial assistance to the § 10(b) violation by failing to determine that the appraisal was incorrect before the issuance of the 1988 bonds. Substantial assistance generally requires some affirmative action, and therefore, Central Bank's failure to uncover the inaccuracy in the appraisal should not have given rise to aider and abettor liability. *See* Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N. CAR. L. REV. 691, 761 (1997) ("Before *Central Bank*, most courts held that mere silence or inaction could not give rise to even aiding and abetting liability, not to mention primary liability.").

Accordingly, there was no genuine issue of material fact with respect to Central Bank's secondary liability for aiding and abetting a primary § 10(b) violation by the property developer that provided the appraisal to Central Bank. Rather than rejecting secondary liability for aiding and abetting in all § 10(b) cases, this Court should have applied the common law requirements for secondary liability that an aider and abettor must have provided substantial assistance to a § 10(b) violation while having actual knowledge that it was participating in a scheme in which each of the elements for § 10(b) liability were satisfied.

The conduct of Central Bank was qualitatively different than the conduct of the defendants alleged in this case. The plaintiffs have alleged that Charter Communications, Inc. ("Charter") asked the defendants to "enter into a scheme with it which would falsely inflate Charter's publicly reported year-end revenue and operating cash flow in order to artificially inflate Charter's stock price." Petition for a Writ of Certiorari 4. The scheme entailed paying the defendants an additional $20 for each set-top box that Charter purchased from them, but this amount would be recouped from the defendants by their purchasing an equivalent dollar amount of advertising from Charter. Charter would then treat the $20 it "paid" for each set-top box as a capital expenditure, while booking the $20 it "received" from the defendants for advertising as revenue, thereby increasing both the revenue and operating cash flow that Charter publicly reported. In contrast to Central Bank, which merely failed to discover that the primary violator's appraisal was inflated, the defendants in this case are alleged to have actively provided substantial assistance to Charter's § 10(b) violation by amending contracts involving the sale of hundreds of thousands of their products and entering into advertising contracts for millions of dollars to offset the revenue from the sales contract, knowing their purpose was to misstate Charter's revenues and operating cash flow in its financial statement. The plaintiffs have alleged that the defendants went so far as to agree to back date documents to give the false impression to outside auditors and others that the contracts for the sales of the set-top boxes were unrelated to the advertising contracts. *Id.* at 6, 7. If the outside auditors had known that these transactions were interrelated, they would not have permitted Charter to utilize the accounting treatment that charter used in its financial

statements. The attempt by the defendants to cover up the transactions demonstrates that the defendants had actual knowledge of the wrongful purpose for the transactions, which was to inflate the revenue and operating cash flow that Charter publicly reported.

Accordingly, this case presents dramatically different facts from those in *Central Bank*, and the *Central Bank* decision should not stand in the way of this Court's recognition of common law principles of secondary liability with respect to securities law violations. The common law principles of secondary liability are carefully calibrated to provide redress against culpable persons who cause harm to others indirectly through intermediaries, while at the same time protecting innocent bystanders from being exposed to frivolous claims. Under RESTATEMENT (SECOND) OF TORTS § 876(b), secondary liability for aiding and abetting is restricted to persons who both provide substantial assistance to tortious conduct and have actual knowledge of the tortious conduct. Actors such as the accountants in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), who conducted an audit of a brokerage firm but failed to uncover securities fraud, could not be liable as aiders and abettors, because they could not possibly have had knowledge of fraud that they failed to uncover. Even actors who have actual knowledge of securities law violations would not be subject to secondary liability under the common law principles, unless they provided substantial assistance to the securities law violations. Mere inaction or silence, even with knowledge of wrongful activities, would not subject a person to secondary liability under RESTATEMENT (SECOND) OF TORTS § 876(b). Thus, the corporation in *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), should not have been subject to secondary liability for failing to report the § 10(b) violations of its

brokerage firm, because there was no evidence that the corporation acted in any affirmative way to provide substantial assistance to the § 10(b) violations.

There are a variety of circumstances in which secondary actors might be liable for securities violations if the Court applied the common law principles in the RESTATEMENT (SECOND) OF TORTS §§ 876, 877. A secondary actor who comes up with a deceptive scheme and then persuades another person to carry it out would be liable for inducing a securities violation under RESTATEMENT (SECOND) OF TORTS § 877(a). For example, an investment banker might develop a deceptive scheme and encourage its clients to use the deceptive scheme to misstate their earnings. Alternatively, a secondary actor might conspire with another person to pursue a deceptive scheme and be liable for acting in concert to commit a securities violation under RESTATEMENT (SECOND) OF TORTS § 876(a). Finally, as in this case, a secondary actor who did not originate a deceptive scheme on its own, but instead provided substantial assistance to another person to carry out the deceptive scheme with the awareness that the other person was using the secondary actor's assistance to commit a securities violation, would be liable under RESTATEMENT (SECOND) OF TORTS § 876(b). None of these scenarios was addressed by the *Central Bank* decision, and it is unlikely that Congress would have intended to shield all of these secondary actors from liability for securities law violations, when they would clearly be liable under the common law principles summarized in the RESTATEMENT (SECOND) OF TORTS.

The lack of an express provision in the Private Securities Litigation Reform Act of 1995 for private aiding and abetting actions should not prevent this Court from

recognizing common law principles in a narrow range of cases to provide redress to victims of securities fraud against secondary actors who either induce § 10(b) violations or provide substantial and knowing assistance to primary § 10(b) violators. The 1995 Legislative History states that the Banking, Housing, and Urban Affairs Committee believed that providing explicitly for private aiding and abetting actions would be contrary to the legislation's goal of reducing meritless securities litigation. S. Rep. No. 104-98, at 19, *reprinted in* 1995 U.S.C.C.A.N. 679, 698. Neither the 1934 nor the 1995 Congresses could have intended, however, for all secondary actors to be shielded from liability, even if they induced others to commit § 10(b) violations, conspired with primary violators, or aided and abetted primary violators by providing substantial assistance while having actual knowledge of the primary violations. Congress also could not have intended that lawyers should be able to advise clients that as long as they do not engage in deceptive practices themselves, they will be immune from liability under the securities laws.

CONCLUSION

The plaintiffs have alleged that the defendants provided substantial assistance to Charter's scheme to misstate Charter's operating income and revenue in order to inflate Charter's stock price. This substantial assistance involved the defendants entering into offsetting agreements with Charter that increased the price of set-top boxes that Charter purchased from the defendants in return for advertising for the defendants. The defendants benefited from free advertising from Charter, while Charter

used these transactions to commit a § 10(b) violation by misrepresenting its operating income and revenue in its financial statements. In order to cover up the relationship between the offsetting agreements, the defendants agreed to back date them. The cover up makes evident the defendants' actual knowledge of the unlawful purpose of the offsetting agreements. Accordingly, the plaintiffs have satisfied the requirements for alleging a claim for the defendants to be secondarily liable as aiders and abettors of Charter's § 10(b) violation. Despite the broad language in *Central Bank* concerning aider and abettor liability, this Court should recognize secondary liability for aiding and abetting a § 10(b) violation under the facts of this case, because Congress could not have intended that the defendants would escape liability for their actions.

Respectfully submitted,

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No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE AMERICAN ASSOCIATION FOR JUSTICE AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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IDENTITY AND INTEREST OF *AMICUS CURIAE*

The American Association for Justice ("AAJ"), formerly the Association of Trial Lawyers of America, respectfully submits this brief as *amicus curiae* in support of petitioner. TThis brief is filed with consent of all parties. Petitioner's letter is on file with this Court. Respondent's letters are attached.[1]

AAJ is a voluntary national bar association whose approximately 50,000 trial lawyer members primarily represent individual plaintiffs in personal injury cases and other civil actions, including securities fraud suits. Throughout its 40-year history, the association has fought to preserve the protections for ordinary citizens afforded by the common law and to ensure that remedial legislation such as the Securities Exchange Act of 1934 is construed to provide injured persons with an effective remedy against those who have wrongfully harmed them through fraud or other misconduct.

SUMMARY OF THE ARGUMENT

1. The Court of Appeals erred in limiting the reach of § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78 *et.seq.* (1934) to actors in a scheme to defraud investors who themselves make a material

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[1] Pursuant to Supreme Court Rule 37.6, Amicus discloses that no counsel for a party authored any part of this brief, nor did any person or entity other than Amicus Curiae, its members, or its counsel make a monetary contribution to its preparation.

misstatement or omission or commit a manipulative act. This conclusion was based on a misreading of this Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver,* 511 U.S. 164 (1994). The language of § 10(b) and of the Securities and Exchange Commission's implementing rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5 (Rule 10b-5) is not so limited. The decisions of this Court—including *Central Bank* itself and subsequent rulings—make clear that these provisions reach deceptive acts perpetrated by secondary actors in furtherance of a scheme to defraud.

2. Contemporaneous understandings of fraud support this reading of § 10(b). Dictionary definitions, common law precedents, and the first Restatement of Torts all demonstrate that at the time the Exchange Act was drafted the concept of fraud encompassed deceptive conduct. The Restatement also confirms that liability for fraudulent misrepresentation extended to actors whose deceptive conduct, indirectly communicated to another, was intended to influence the other's conduct in a transaction with a third person.

3. The proper test for distinguishing primary § 10(b) liability from aiding and abetting should focus on whether a defendant personally engaged in deceptive or manipulative actions in furtherance of a fraudulent scheme. Under such a test, Petitioner has alleged satisfactorily that both Scientific-Atlanta, Inc., and Motorola, Inc., have committed violations of that section and Rule 10b-5(a) and (c).

ARGUMENT

I. The Language of Section 10(b) of the Securities Exchange Act and Rule 10b-5 (a) and (c), as well as the Decisions of this Court, All Justify Imposing Primary 10(b) Liability on a Party Who Engages in Deceptive Acts as Part of a Scheme to Defraud Purchasers or Sellers of Securities.

Contrary to the conclusion of the Court of Appeals below, neither § 10(b) of the Securities Exchange Act nor Rule 10b-5, the Securities Exchange Commission (SEC) rule implementing that section, is limited to material misstatements and omissions (and manipulative acts), thereby excluding deceptive conduct from their reach. Section 10(b) states, in pertinent part:

> It shall be unlawful for any person, *directly or indirectly*, . . . (b) *[t]o use or employ*, in connection with the purchase or sale of any security . . . , *any* manipulative or *deceptive device or contrivance* in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (emphases added). Rule 10b-5, in turn, provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, . . . (a) [t]o employ

> any device, scheme, or artifice to defraud, . . . or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5(a) and (c).[2]

Both the statute and rule are broad enough, on their face, to reach deceptions by deed as well as by word. They cover, expressly, deceptive "devices," "contrivances," "schemes [and] artifices to defraud," and "acts, practices, [and] courses of business" which operate as a fraud or deceit, by "any person," both "direct [and] indirect." This Court has repeatedly instructed that the statutory text must be the starting point for interpretation. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976). So the Court's inquiry could end right here.

But there is much more. The "fundamental purpose" of the 1934 act and its companion enactments was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963). Therefore, both before and after *Central Bank*, this Court has instructed that section 10(b) and related securities legislation "enacted for the purpose of avoiding frauds" must "be construed 'not technically and restrictively, but flexibly to effectuate

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[2] Rule 10b-5(b), by contrast, does require an express "untrue statement" or omission of a material fact.

its remedial purposes.'" *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (quoting *Capital Gains Research Bureau*, 375 U.S. at 195); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. Zandford*, 535 U.S. 813, 819 (2002).

Time and time again this Court has announced that § 10(b) was intended to bar securities fraud in all of its various guises. *See, e.g., Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) ("the statute provides a cause of action for any plaintiff who 'suffer(s) an injury as a result of deceptive practices touching its sale (or purchase) of securities.'") (quoting *Superintendent of Ins.*, 404 U.S. at 12-13; *Affiliated Ute*, 406 U.S. at 151 ("These proscriptions, by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive."); *Superintendent of Ins.*, 404 U.S. at 11 n.7 ("'We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud or present a unique form of deception. Novel and atypical methods should not provide immunity from the securities laws.'") (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967); *Ernst & Ernst*, 425 U.S. at 203 (Section 10(b) "was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.'").[3]

Despite this unambiguous guidance from this Court, the court below latched onto some loosely

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[3] *Cf. Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.").

written language from *Central Bank* to conclude – erroneously – that § 10(b) liability does not extend to any defendant "who does not make or affirmatively cause to be made a fraudulent misstatement or omission," regardless of whether that defendant engaged in deceptive acts as part of a scheme to defraud. *In re: Charter Commc'n, Inc., Sec. Litig.* 443 F.3d 987, 992 (8th Cir. 2006).[4] The Court of Appeals quoted a passage from *Central Bank* that read: "As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," *id.* at 990 (quoting 511 U.S. at 177), and incorrectly took it to mean that "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b) absent some misstatement or failure to disclose by one who has a duty to disclose." *Id.* at 992.

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[4] This would not be the first time that the Eighth Circuit took a sentence from *Central Bank* out of context and read too much into it. In *O'Hagan v. United States*, 92 F.3d 612, 619 (8th Cir. 1996), the Eighth Circuit "isolated the statement" from *Central Bank* that "[a]ny person or entity . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5. . ." and "drew from it the conclusion that § 10(b) covers only deceptive statements or omissions on which purchasers or sellers, and perhaps other market participants, rely." *United States v. O'Hagan*, 521 U.S. 642, 664 (1997). This Court, reversing, explained: "It is evident from the question presented in *Central Bank*, however, that this Court, in the quoted passage, sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under § 10(b) and Rule 10b-5 for certain conduct." *Id.*

It should have been clear from context that the passage quoted from *Central Bank* used the phrase "material misstatement (or omission)" simply as shorthand for deceptive conduct, in order to distinguish persons who engage in such conduct from those who merely aid and abet, the issue before the Court.[5] Elsewhere in the opinion this Court could not have been more explicit: "In §10(b), Congress *prohibited* manipulative or *deceptive acts* in connection with the purchase or sale of securities." 511 U.S. at 173 (emphasis added).[6]

Moreover, any possible ambiguity left by *Central Bank* about § 10(b)'s application to deceptive conduct has been resolved by subsequent rulings of this Court. In *SEC v. Zandford* 535 U.S. 813 (2002), this Court held unanimously that a securities broker's alleged conduct of selling his clients' securities with the undisclosed intent to misappropriate the proceeds constituted fraud

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[5] Indeed, as Petitioner observed in its Petition for Certiorari, the quoted passage in *Central Bank* was supported by citations to prior caselaw that referred more broadly to "manipulation and deception" and immediately followed by two sentences that linked the scope of § 10(b) to "manipulative or deceptive acts." Pet. for Cert. at 15-16 (quoting 511 U.S. at 177-78). Because respondents in *Central Bank* had conceded that the bank "did not commit a manipulative or deceptive act within the meaning of § 10(b)," *id.* at 191, it was not necessary for the Court in that case to precisely define those terms.

[6] *See also id.* at 177-78 ("We cannot amend the statute to create liability for *acts* that are not themselves manipulative or deceptive within the meaning of the statute.") (emphasis added).

under § 10(b).[7] The Court emphasized that it was the broker's acts, not his words, which violated the act: "Indeed, each time respondent 'exercised his power of disposition for his own benefit,' that conduct, 'without more,' was a fraud. In the aggregate, the sales are properly viewed as a 'course of business' that operated as a fraud or deceit on a stockbroker's customer." *Id.* at 821.[8]

This Court was even more explicit that a violation of § 10(b), and of Rule 10b-5(a) and (c),[9] does not require a material misstatement or omission in *Wharf (Holdings) Ltd. v. United Inernational Holdings, Inc.*, 532 U.S. 588 (2001). In *Wharf*, this Court held, again unanimously, that a company that sold an option to purchase stock in a cable television system with the secret intent not to honor that option violated Rule 10b-5. In the course of the opinion, the Court stated that Rule 10b-5 forbids the use of "four kinds of manipulative or deceptive devices": "(1) 'any device,

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[7] The central issue in *Zandford* was whether the broker's conduct satisfied the "in connection with the purchase or sale of any security" requirement of § 10(b). No one questioned whether his fraudulent scheme constituted a "deceptive device or contrivance" under the act.

[8] Elsewhere in the opinion this Court expressly disclaimed that a violation of § 10(b) required a "misrepresentation": "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id.* at 820.

[9] This Court has determined that the "scope of Rule 10b-5 is coextensive with the coverage of § 10(b). *See SEC v. Zandford*, 535 U.S. at 816 n.1; *U.S. v. O'Hagan*, 521 U.S. at 651; *Ernst & Ernst*, 425 U.S. at 185.

scheme, or artifice to defraud'; (2) 'any untrue statement of a material fact'; (3) the omission of 'a material fact necessary in order to make the statements made . . . not misleading'; or (4) any other 'act, practice, or course of business' that 'operates . . . as a fraud or deceit." *Id.* at 593 (2000).[10] The Court then explained that "[t]o succeed in a Rule 10b-5 suit, a private plaintiff must show that the defendant used, in connection with the purchase or sale of a security, *one* of the four kinds of manipulative or deceptive devices to which the Rule refers . . ." *Id.* (emphasis added). That is to say, a plaintiff can prevail on a 10b-5 claim by proving a violation of Rule 10b-5(a) or (c) (the first and fourth kinds of deceptive devices identified by the Court), without demonstrating any material misstatement or omission (the second and third kinds).

Thus, the language of § 10(b) and Rule 10b-5, as well as the decisions of this Court, both before and after *Central Bank,* make it unlawful for any person, in connection with a securities transaction, to engage in deceptive conduct in furtherance of a scheme to defraud. As will be seen in the next section, this construction of § 10(b) is also entirely consistent with the understanding of fraud at common law and at the time of the enactment of the Exchange Act.

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[10] This division of Rule 10b-5 obviously tracks its three subparts, with section 10b-5(b) divided in two in order to distinguish material misstatements from material omissions.

II. Contemporaneous Understandings of Fraud Encompassed Such Deceptive Conduct and Should Inform this Court's Construction of the 1934 Act.

In an attempt to discern Congress's meaning when it enacted the Exchange Act—and to flesh out the terms of the private right of action implied under § 10(b)—courts often look to contemporaneous sources that may provide insight into the meaning of statutory terms. At least three sets of sources from around the time of enactment—dictionaries, common law precedent, and the first Restatement of Torts—each provide a broad understanding of actionable fraud that lends support to Petitioner's claims in this case.

A. Dictionary Definitions

In *Ernst & Ernst,* this Court turned to contemporaneous dictionaries in order to determine the "commonly accepted meaning" of the "operative language" of § 10(b).[11] 425 U.S. at 199:

> Webster's International Dictionary (2d ed. 1934) defines "device" as "(t)hat which is devised, or formed by design; a contrivance; an invention; project;

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[11] The Court explained its focus on commonly accepted meaning with a quotation from *Addison v. Holly Hill Fruit Prod., Inc.*, 322 U.S. 607, 617-18 (1944): "After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him." *Ernst & Ernst,* 425 U.S. at 199 n.19.

> scheme; often, a scheme to deceive; a stratagem; an artifice," and "contrivance" in pertinent part as "(a) thing contrived or used in contriving; a scheme, plan or artifice." In turn, "contrive" in pertinent part is defined as "(t)o devise; to plan; to plot ... (t)o fabricate . . . design; invent . . . to scheme . . . "

Id., n.20. The Court cited these definitions to support a scienter requirement for § 10(b) liability, but they also support an expansive reading of the kinds of "device or contrivance" covered by the statute.

Other dictionaries from the same era provide equally broad definitions of "fraud" and "deception." *See Black's Law Dictionary* 529 (3d ed. 1933) (defining "deception" as "[t]he act of deceiving; intentional misleading by falsehood spoken or acted."); *Eliason v. Wilborn*, 335 Ill. 352, 357 (1929) ("The *Century Dictionary* defines fraud as 'an act or course of deception deliberately practiced with the view of gaining a wrong or unfair advantage; deceit; trick; an artifice by which the right or interest of another is injured.'"); *id.* at 358 ("1 Bouv. Law Dict. p. 1304, states that active and positive fraud includes cases of the intentional and successful employment of any cunning, deception, or artifice to circumvent, cheat, or deceive another."). These definitions not only track much of the language that ultimately found its way into Rule 10b-5, they also clearly establish the contemporaneous understanding that fraud could be accomplished by acts as well as words.

B. Common Law Precedent

Similarly, this Court and lower courts have looked to the common law for guidance about how to construe § 10(b). Private securities fraud actions judicially implied under this section have "common-law roots", *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 344 (2005), and "resemble in many (but not all) respects common-law deceit and misrepresentation actions." *Id.* at 343 (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975), and L. Loss & J. Seligman, *Fundamentals of Securities Regulation* 910-18 (5th ed. 2004)). Although actions under § 10(b) are "distinct from" common-law causes of action, *Basic Inc. v. Levinson*, 485 U.S. 224, 244 n.22 (1988). Indeed, the statutory cause of action is generally understood to be substantively broader and to provide more protection to investors than the common law. *Id.* (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983); *see generally* Arnold S. Jacobs, 5B *Disclosure and Remedies Under the Securities Laws* § 6:50 (2005).

There can be no doubt that the common law recognized, and made actionable, fraud by deceptive conduct. In the seminal English case of *Scott v. Brown, Doering, McNab & Co.*, [1892] 2 Q.B. 724 (C.A.), the court held unlawful an agreement among the parties to purchase shares in a company in order to induce others who might thereafter consider investing to believe, falsely, that there was a *bona fide* market for the shares: "an agreement to cheat the public by leading them to believe the shares had a value, which the plaintiffs and defendants knew they had not, and thus inducing them to become purchasers. Is such a transaction illegal? I am of opinion that it is, and might be made the subject

of an indictment for conspiracy." *Id.* at 730 (Lopes, L.J.). To Lord Lopes it was irrelevant that the deception had been carried out by deeds, rather than words: "I can see no substantial distinction between false rumours and false and fictitious acts; the price of the shares in this case was artificial, and the premium unreal and nominal, to the knowledge of all parties concerned, put forward to induce the public to take shares, with which otherwise they would have had nothing to do." *Id.* at 730-31.[12]

Scott was followed in a federal mail fraud case, *United States v. Brown*, 5 F. Supp. 81 (S.D.N.Y. 1933, the year before the Exchange Act was enacted. *Brown* involved a pooling scheme to artificially raise the price of the stock of a company listed on the stock exchange. Overruling the defendants' demurrer to their indictment, the court explained, in language that could be directly applied to this case: "It is obvious that, when two or more persons, by a joint effort, raise the price of a listed stock artificially, they are creating a kind of price mirage which may lure an outsider into the market to his damage. . . . [S]uch a procedure would of itself constitute a fraud on the public." *Id.* at 93 (citing *Scott*). *See also Schreiber v. Burlington Northern,*

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[12] *See also* the opinion of Lord Lindley, who found the fraud unlawful even though the purchase transactions were real: "The plaintiff's purchase was an actual purchase, not a sham purchase; that is true, but it is also true that the sole object of the purchase was to cheat and mislead the public." *Id.* at 728. *A fortiori*, sham transactions designed to mislead the public, such as those the Respondents are alleged to have entered with Charter Communications, would constitute fraud.

Inc., 472 U.S. 1, 7 n.4 (1985) (favorably citing *Scott* and *Brown* in federal securities litigation).

A second line of common-law decisions derives the principle that fraud can be effected by conduct from a statement attributed to the Lord Chancellor (Lord Cairns) in the House of Lords: "If one conducts himself in a particular way, with the object of fraudulently inducing another to believe in the existence of a certain state of things, and to act upon the basis of its existence, and damage resulted there from to the party misled, he who misled him will be just as liable as if he had misrepresented the facts in express terms." *See Pennebaker v. Kimble*, 269 P. 981, 984 (1928); *Berkowitz v. Lyons*, 119 A. 20, 22 (N.J. 1922).[13] *Berkowitz*, which involved the fraudulent sale of a stolen automobile, goes on to say that "want of ownership and actual misrepresentations of fact are not the sole basis of actionable fraud, since the deceit and fraud practiced can as well effectuate its baneful purpose by conduct as it can by words." 119 A. at 21. To the same effect, *see Pennebaker*, 269 P.2d at 984 ("To communicate a representation, it is not necessary that the party should speak words or write a message. The desired result may be accomplished oft times by conduct."). And the

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[13] Both cases attribute this quotation to the case of *Northeastern Ry. Co. v. Wanless*, (1874-75) LR 7 H.L. 12, but it does not appear therein. Both cases also cite the following general description of deceit: "It may consist in the creation of a false impression by words or acts, or by any trick or device, a deep laid scheme of swindling, or a direct falsehood, a combined effort of a number of associates or the sole effort of a solitary individual." *Id.* (citing "12 R.C.L. 232").

Oregon Supreme Court describes the principles of law involved as "old and well established." *Id.* at 983.[14]

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[14] There is yet a third line of common-law cases that may be relevant, those having to do with the doctrine of "negative deceit," which holds—even in the absence of fiduciary obligations or material misrepresentations—that "in some circumstances the suppression of a truth may be equivalent to the assertion of a falsehood." *Crompton v. Beedle*, 75 A. 331, 333 (Vt. 1910); *see also Noved Realty Corp. v. A.A.P. Co.*, 293 N.Y.S. 336 (N.Y. 1937); *Downey v. Finucane*, 98 N.E. 391 (N.Y. 1912); *Stewart v. Wyoming Cattle Ranche Co., Ltd.*, 128 U.S. 383 (1888). These cases trace back to Chief Justice Marshall's decision for this Court in *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817), in which it was held that it was a question for the jury whether a vendee's failure to disclose to a vendor the existence of our nation's peace treaty with England (which was likely to have a significant effect on the value of the goods to be purchased) was an improper "imposition." As this Court later explained in *Stewart:*

> [M]ere silence is quite different from concealment. *Aliud est tacere, aliud celare,*-a suppression of the truth may amount to a suggestion of falsehood....The gist of the action [of deceit] is fraudulently producing a false impression upon the mind of the other party; and, if this result is accomplished, it is unimportant whether the means of accomplishing it are words or acts of the defendant, or his concealment or suppression of material facts not equally within the knowledge or reach of the plaintiff.

128 U.S. at 388. In this case, the disclosure of the respondents purchase of advertising from Charter, while suppressing the fact that Charter had itself paid for that advertising through fraudulently inflated contracts for set-

It is thus indisputable that the common law recognized a cause of action for fraud by deceptive conduct, even in the absence of any material misrepresentations.

C. The Restatement of Torts

Finallywe turn to the Restatement of Torts. This Court has often resorted to the Restatement for guidance regarding the "judicial consensus" about the meaning of the common law. *See, e.g., Dura Pharm., Inc. v. Broudo,* 544 U.S. at 343-44 (citing Restatement (Second) of Torts §§ 525, 548A); *Wharf (Holdings) Ltd.,* 532 U.S. at 596 (citing Restatement (Second) of Torts § 530). In construing the 1934 Exchange Act, it seems particularly appropriate to look to the first Restatement, which was itself a product of the 1930s, and thus reflects the judicial consensus at the time Congress enacted § 10(b).

Provisions of the first Restatement support a construction of § 10(b) that reaches the alleged conduct of Scientific-Atlanta and Motorola. To begin with, § 525 of the Restatement is explicit that the tort of fraudulent misrepresentation may be committed by conduct as well as words. Comment *b* to that section states, in relevant part: "*Misrepresentation defined.* 'Misrepresentation' is used in this Chapter to denote not only words spoken or written but also any other *conduct* which amounts to an assertion not in

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top boxes, would seem to constitute just such a deceit through concealment.

accordance with the truth." Restatement (First) of Torts § 525 Comment *b* (1938) (emphasis added).

Section 533 of the Restatement, and the comments thereto, go further and make clear that the tort may be committed, even though the defendant has no direct communication with the person defrauded and no economic interest in the transaction influenced by the fraud. Section 533 states:

> § 533. Representation Made Through A Third Person. The maker of a fraudulent misrepresentation in a business transaction is subject to liability to another who acts in justifiable reliance upon it if the misrepresentation, although not made directly to the other, is made to a third person for the purpose of having him repeat its terms or communicate its substance to the other in order to influence his conduct in a particular transaction or type of transaction.

Restatement (First) of Torts § 533. Comment *a* to this section addresses its applicability to transactions in which the maker has no interest:

> *a. Inducing action between third persons.* The rule stated in this Section is applicable not only where the maker's purpose is to influence by its repetition the conduct of another in a transaction with the maker but also where his purpose is to influence the

> other's conduct in a transaction with a third person.

Id., Comment *a*. Further, as Comment *e* explains, the defendant need not even know the person to whom the fraud will be repeated, so long as that person is a member of the class it intends to influence through its fraudulent conduct:

> *e. Repetition to unidentified person.* While the maker of the representation is liable only if it is repeated to a person to whom it is his purpose to have it repeated or to whom its repetition is authorized, it is not necessary that he have any particular person in mind. It is enough that his purpose is to have it repeated to a particular class of persons and that the person relying upon it is one of that class.

Id., Comment *e*.

Thus, whether one looks to dictionaries of the time, common law precedent, or the Restatement of Torts, there can be no doubt that, at the time the Exchange Act was enacted, the contemporaneous understanding of fraud, deceit and misrepresentation was quite broad, and would have imposed tort liability for conduct comparable to that in which Respondents are alleged to have engaged. Congress legislated against that legal backdrop and therefore should be understood to have used similar legal terminology and concepts in an equally sweeping way.

III. The Appropriate Test to Distinguish Primary § 10(b) Liability from Aiding and Abetting Should Focus on Whether the Defendant Itself Engaged in Deceptive or Manipulative Conduct as Part of a Fraud Scheme.

The question then becomes: what test to employ in order to identify conduct by secondary actors that gives rise to liability under § 10(b)? As amicus hopes the foregoing discussion illustrates, the proper test cannot be one—like the test adopted by the Court of Appeals below—that arbitrarily distinguishes between different categories of fraudulent or deceptive behavior, holding some liable for federal securities fraud while allowing others to get off scott free. At the same time, in order to be consistent with *Central Bank*, the test must distinguish between primary liability under § 10(b) and mere aiding and abetting.

The answer, it seems to amicus, comes from the guidance provided by this Court at the conclusion of its *Central Bank* opinion: "In any complex securities fraud . . . there are likely to be multiple violators"; "[a]ny person or entity" involved in such a fraud scheme "may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191.

The key requirement under § 10(b) and Rule 10b-5, and the one that most dramatically distinguishes conduct in violation of those provisions from aiding and abetting, is—in the language of the statute—the "use or employ[ment of] . . . any manipulative or deceptive device or contrivance." Defendants in 10b-5 actions who themselves engaged in manipulative or

deceptive conduct – in the broad meaning of those terms intended by Congress, articulated by this Court, and supported by the act's common-law antecedents – should be held to account for their actions.

Not surprisingly, given that it derives from this Court's guidance in *Central Bank*, this proposed test focused on the deceptive nature of the defendants' own conduct is quite similar to tests for §10(b) liability suggested by other actors and courts. In *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006), a factually similar case decided last year by the Court of Appeals for the Ninth Circuit, the SEC had proposed the following test:

> Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5; any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

Brief of the SEC, *Amicus Curiae*, in Support of Positions that Favor Appellant, *Simpson v. Homestore.com, Inc.*, No. 04-55665 (9th Cir. Filed Oct. 22, 2004), at 16. When the Ninth Circuit ultimately rendered its decision in the case it adopted a similar, though somewhat narrower, standard: "to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false

appearance of fact in furtherance of the scheme." 452 F.3d at 1048.[15]

Other courts have employed similar language to similar effect. *See, e.g., In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) ("better reading of § 10(b) and Rule 10b-5 is that they impose primary liability on any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market"); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 503 (S.D.N.Y. 2005) (adopting *Lernout & Hauspie* test without the "substantial participation" requirement). Indeed, as this Court noted in *Central Bank*, even before that decision "the Seventh Circuit ha[d] held that the defendant must have committed a manipulative or deceptive act to be liable under § 10(b), a requirement that in effect forecloses liability on those who do no more than aid or abet a 10b-5 violation." 511 U.S. at 170 (citing *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986)).

Under any of these similar but variously-phrased tests, Petitioner has adequately alleged a §

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[15] *See also* that court's earlier ruling, *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998) ("*Central Bank* does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme.").

10(b) violation by each Respondent. Petitioner alleges that both Scientific-Atlanta and Motorola entered into sham transactions with Charter Communications in which they agreed to "purchase" advertising from Charter with funds that Charter would funnel to them through increased payments for set-top cable boxes in excess of existing contract terms. In furtherance of this scheme, Petitioner alleges that Scientific-Atlanta created a fraudulent document to justify the price increase and that both Respondents backdated contract documents to conceal the sham nature of the transactions. Moreover, Petitioner alleges that the Respondents understood that the purpose of this scheme was to allow Charter to falsely report higher revenue and operating cash flow in its public financial statements. Pet. for Cert. at 3-7. There can be no doubt that Petitioner has alleged satisfactorily that both Scientific-Atlanta and Motorola have employed deceptive devices or contrivances in connection with securities transactions in contravention of Rule 10b-5(a) and (c). Petitioner should now be given an opportunity to prove these allegations in court.

CONCLUSION

For the foregoing reasons, Amicus urges this Court to reverse the decision of the Eighth Circuit and remand for further proceedings.

Respectfully submitted,

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

—v.—

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE AMERICAN BANKERS ASSOCIATION, THE ABA SECURITIES ASSOCIATION, THE CLEARING HOUSE ASSOCIATION L.L.C. AND THE FINANCIAL SERVICES ROUNDTABLE AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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STATEMENT OF INTEREST OF *AMICI CURIAE*[1]

The American Bankers Association ("ABA") is the principal national trade association of the financial services industry in the United States. Its members, located in each of the fifty States and the District of Columbia, include financial institutions of all sizes and types, both federally and state-chartered. ABA members hold a majority of the domestic assets of the banking industry in the United States.

The ABA Securities Association ("ABASA") is a separately chartered trade association and non-profit affiliate of the American Bankers Association. ABASA is devoted to forming and exploring policy that relates to banking organizations involved in the securities business.

The Clearing House Association L.L.C. (the "Clearing House"), founded over 150 years ago, is an association of eleven leading commercial banks that, through an affiliate, provides payment, clearing and settlement services to its member banks and other financial institutions.

The Financial Services Roundtable is a national association whose membership includes 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer.

The ABA, ABASA, Clearing House and Financial Services Roundtable (collectively, "*Amici*") regularly present the views of their members on important public policy issues

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[1] Pursuant to Rule 37.6, counsel certifies that this brief was not authored, in whole or in part, by counsel for any party, and no person or entity other than *Amici*, their members, and their counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of the brief and copies of their letters of consent have been lodged with the Clerk of the Court.

that impact the financial services industry by, among other things, appearing as *amicus curiae* in this Court.

The issue presented here—whether this Court should create a private cause of action under Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") against banks and other financial institutions, vendors, law firms and other third parties that do business with publicly-traded companies—is of critical importance to *Amici* and the Nation's economy. The plaintiffs' bar in securities class actions reflexively targets the "deep pockets" of financial services companies when the issuer or other primary actors, including the issuer's executives, are bankrupt or otherwise judgment-proof. These strike suits reduce the efficiency and competitive position of the U.S. capital markets.

Petitioner has developed a so-called "scheme" theory that largely would eviscerate not only this Court's holding in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), that Section 10(b) does not permit a private cause of action for aiding and abetting, but also Congress's subsequent express refusal to grant such authority to private plaintiffs in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). If this Court accepts Petitioner's open-ended theory, private plaintiffs could sue all financial institutions that did business with a public company simply by claiming that the financial institution was part of the public company's "scheme to defraud."

Under Petitioner's "scheme" theory, the liability of a financial institution would turn on whether the "purpose and effect" of a transaction was to portray falsely a company's financial condition. Because of the inherently amorphous nature of Petitioner's proposed legal standard, financial institutions could face potentially ruinous liability based on their mere participation in routine financial-markets transactions whenever a public company is accused of misrepresentation in respect of that transaction.

Moreover, because of the highly subjective nature of Petitioner's proposed legal standard, financial institutions would be unable to extricate themselves from meritless class actions at the motion to dismiss stage. Instead, faced with the risk that a jury could enter a massive damages award, financial institutions would be coerced into costly and unfair settlements. Such a legal regime would, in effect, make financial institutions insurers for losses suffered by investors in public companies.

This Court should not rewrite the securities laws. If adopted, Petitioner's "scheme" theory would negatively impact the availability of bank financing and risk-mitigation transactions, deter socially beneficial economic transactions, impair the proper functioning of this Nation's financial markets and, ultimately, threaten the safety and soundness of individual financial institutions and the Nation's banking system.

STATEMENT OF THE CASE

Plaintiffs filed this class action on behalf of certain present and former shareholders of Charter Communications, Inc. ("Charter"), a cable television provider, against Charter itself and its executives and auditor, as well as Scientific-Atlanta, Inc. and Motorola, Inc., two equipment vendors that had done business with Charter ("Vendors"). Plaintiffs alleged that Charter defrauded plaintiffs through the issuance of false and misleading financial statements. Plaintiffs further alleged that the Vendors were liable as primary violators of Section 10(b) of the 1934 Act because they participated in a "scheme to defraud" by engaging in certain "sham" business transactions with Charter.

Petitioner contends that the Vendors should be liable for participating in these "sham transactions" because the Vendors knew that Charter would use those transactions "to further the scheme to overstate [its] revenue and operating cash flow in financial statements which were filed with the SEC and issued to the investing public." (Pet. Br. 9, 12.)

Petitioner further claims that the Vendors "deceived" Charter's auditor about the nature of the transactions by "backdating" and otherwise falsifying certain transaction documents. (*See id.* at 6-9; J.A. 55a-60a (SAC ¶¶ 100-10).) Petitioners do not allege that the Vendors were involved in, or had any control over, Charter's accounting and financial reporting of the challenged transactions.

The district court dismissed the Section 10(b) claims brought against the Vendors, finding that their alleged conduct amounted to aiding and abetting, not a primary violation of Section 10(b). (Pet. App. 69a.) The Eighth Circuit affirmed. (*Id.* at 10a-11a.)

SUMMARY OF ARGUMENT

This case directly implicates this Court's decision in *Central Bank*, which held that Section 10(b) does not authorize a private cause of action for aiding and abetting a securities fraud. Just a year after *Central Bank*, Congress enacted the PSLRA and expressly decided not to permit a private right of action for "aiding and abetting," while providing the power to bring such claims to the SEC, the expert agency responsible for the supervision of our Nation's securities markets. Because Petitioner's "scheme" theory is but another form of "aiding and abetting" expressed in different terminology, Petitioner and its *amici* effectively ask this Court to overrule *Central Bank* and to ignore Congress's refusal to grant such authority to the plaintiffs' bar in the PSLRA.

In advancing their "scheme" theory, Petitioner and its *amici* argue that the distinction between a primary violation of Section 10(b) and "aiding and abetting" such a violation is nothing more than a legal technicality that should not permit persons with knowledge of the potential for securities fraud to escape responsibility for their actions. This is wrong.

First, it is Congress's prerogative to decide what actions subject a person or entity to civil liability for securities fraud under Section 10(b). In the PSLRA,

Congress exercised that prerogative and clearly decided that, as a matter of national policy, private "aiding and abetting" claims should not be allowed. In so doing, Congress decided that the distinction between a primary violation and aiding and abetting is not a technicality at all, but an important limitation on the reach of Section 10(b) in private class actions.

Second, notwithstanding Petitioner's protestations that secondary actors would enjoy immunity under the Eighth Circuit's standard, aiders and abettors of violations of Section 10(b) are not beyond the reach of the law. In the PSLRA, Congress specifically authorized the SEC to bring enforcement actions against aiders and abettors and, if warranted, to impose large financial penalties and other forms of punitive relief. In addition, such aiders and abettors are subject to federal and state criminal prosecutions and state civil litigation.

By any measure, Petitioner's "scheme" theory is an attempted end-run around Congress's decision not to allow private aiding-and-abetting claims. Fundamentally, Petitioner's "scheme" theory cannot be reconciled with this Court's decision in *Central Bank* that a private plaintiff must establish every element of Section 10(b) against each defendant to establish a primary violation. In particular, as applied to the Vendors' conduct in this case, Petitioner's "scheme" theory would impose liability improperly on the Vendors for conduct that was (1) not relied on by Charter's investors, (2) not "in connection with" the purchase or sale of Charter's securities, and (3) not the cause of the losses allegedly suffered by Charter's investors.

Petitioner's proposed "purpose and effect" test to implement its "scheme" theory also would exacerbate the amount of vexatious securities fraud litigation and thereby undermine one of the central goals of the PSLRA. This test would allow the plaintiffs' bar to cast a broad net, based on a vague and unclear test, to ensnare "deep pocket" secondary

actors such as *Amici*'s members in virtually any securities case based on a public company's alleged misstatements. By contrast, the Eighth Circuit test properly excludes from Section 10(b) civil liability to private parties based on conduct amounting to aiding and abetting, and provides clear guidelines as to what conduct is prohibited.

The claim of certain *amici* that Petitioner's "scheme" theory would have supported a fraud claim against the Vendors at common law is both irrelevant and wrong. As this Court has long held, the common law is irrelevant when this Court has already authoritatively construed a federal statute, particularly when the cause of action has been implied by courts rather than provided by Congress. In any event, the Vendors' conduct here would not constitute fraud at common law because Charter's investors did not *rely* on that conduct; such a claim would constitute, at most, aiding and abetting, which this Court recognized in *Central Bank* was not imported into Section 10(b).

ARGUMENT

I. PETITIONER'S "SCHEME" THEORY WOULD ELIMINATE SEVERAL ESSENTIAL REQUIREMENTS OF SECTION 10(b).

In *Central Bank*, this Court rejected aiding-and-abetting liability under Section 10(b) and squarely held that a plaintiff must prove every element of a Section 10(b) claim as to each defendant based on that defendant's own conduct. Following *Central Bank*, Congress expressly refused to authorize private aiding-and-abetting claims, and chose to permit only an experienced regulator, the SEC, to pursue such claims. *See* PSLRA, Pub. L. No. 104-67, § 104, 109

Stat. 737, 757 (1995) (codified as amended at 15 U.S.C. § 78t(e)).[2]

The requirement that a plaintiff establish that each defendant committed its own primary violation is the critical limitation on liability under Section 10(b). As this Court observed in *Central Bank*, it is the concept of an *independent* primary violation of the statute that provides the demarcation between actionable primary liability under Section 10(b) and non-actionable aiding and abetting. Simply put, a primary violation involves more than "knowing and substantial assistance" of a fraud: There must be a showing that the defendant's conduct, standing alone, satisfies each element of Section 10(b). 511 U.S. at 191.

In contravention of *Central Bank*, Petitioner's "scheme" theory would permit private plaintiffs to pursue aiding-and-abetting claims under a different name. This Court should not permit private plaintiffs to evade *Central Bank* and the PSLRA by labeling conduct part of a "scheme" when that conduct is nothing more than aiding and abetting. Petitioner's effort at evasion is confirmed by its inability to draw a meaningful, much less clear, line between a "scheme" violation and non-actionable aiding and abetting.

A. Petitioner's "Scheme" Theory Would Eliminate the Reliance, "In Connection With" and Loss Causation Requirements of Section 10(b).

By any measure, instead of satisfying the statutory requirement of an independent primary violation, Petitioner's theory would permit plaintiffs in securities fraud cases to bring a Section 10(b) claim against a bank or other financial

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[2] Congress again declined to create a private cause of action for aiding and abetting when it passed the Sarbanes-Oxley Act in 2002, despite requests from some legislators that it do so. *See, e.g.*, H.R. REP. NO. 107-414, at 54 (2002) (minority views); 148 CONG. REC. S6584 (daily ed. July 10, 2002) (amendment submitted by Sen. Shelby).

institution based on the statements and conduct of *other participants* in the alleged scheme. This form of pleading would eviscerate at least three essential elements of a Section 10(b) claim: (i) reliance; (ii) the "in connection with" requirement; and (iii) loss causation.

Reliance. A defendant can be liable under Section 10(b) only if, among other things, the defendant "employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities *relies*." *Central Bank*, 511 U.S. at 191 (emphasis added); *see also id.* at 180 (to prove reliance on a secondary actor, plaintiffs must show they specifically relied on the "statements or actions" of that secondary actor). In *Central Bank*, this Court emphasized the reliance requirement in rejecting the plaintiffs' claim, stressing that "to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." *Id.* at 180 (internal citations omitted). As the Fifth Circuit has observed, "reliance . . . is a specific, defining element of the relevant legal violation . . . ." *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 385 (5th Cir. 2007).

Petitioner does not—and cannot—contend that investors in Charter's securities relied on the Vendors' transactions themselves, or anything else the Vendors are alleged to have done, as opposed to Charter's disclosures to investors. For the transactions *themselves* to have been deceptive, those transactions would need to be deceptive regardless of how they were accounted for and reported by Charter in its financial statements. In fact, after the transactions were executed, Charter could have reported those transactions in accordance with applicable accounting rules and Charter's other disclosure obligations. Charter's failure to comply with these requirements cannot make the Vendors primary violators of the securities laws.

By arguing for reliance on a primary violator's misrepresentation as satisfying the reliance requirement for a secondary actor's conduct, Petitioner seeks to evade a core holding of *Central Bank*. Under Petitioner's theory, an allegation of "scheme to defraud" would eliminate the need for reliance, with the effect of permitting aiding-and-abetting claims as primary violations. This is impermissible. *See also Basic Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988) (proof of reliance is essential because it "provides the requisite causal connection" between a defendant's conduct and a plaintiff's injury).

"In connection with." Section 10(b)'s "in connection with" requirement cannot be satisfied unless a defendant's allegedly wrongful activities "coincide" with the purchase or sale of a security. *SEC* v. *Zandford*, 535 U.S. 813, 822, 824-25 (2002); *United States* v. *O'Hagan*, 521 U.S. 642, 656 (1997). The transactions in question here did not—and indeed could not—"coincide" with any purchases or sales of Charter securities. Rather, it was only Charter's *subsequent* public issuance of financial statements allegedly improperly reflecting the effects of those transactions that could have misled investors in connection with securities transactions.

The "in connection with" requirement is not satisfied by an allegation that the "scheme" itself—an abstract concept representing the undifferentiated aggregation of all defendants' conduct—coincided with the purchase of securities. To ensure that aiders and abettors are not held liable as primary violators, *Central Bank* requires a showing that the conduct of each secondary actor independently satisfies every element of a Section 10(b) claim without regard to the conduct of other defendants. 511 U.S. at 191. This Court should not permit Petitioner to evade the requirements of a Section 10(b) cause of action by talismanically invoking the supposedly magic word "scheme," which does not appear anywhere on the face of Section 10(b). *See Central Bank*, 511 U.S. at 173; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976). Petitioner's

"scheme" theory would effectively read the "in connection with" requirement out of Section 10(b).[3]

Loss Causation. In order to prevail on a claim under Section 10(b), this Court has held that a plaintiff must also prove facts showing "loss causation"—*i.e.*, the causal connection between a defendant's allegedly actionable conduct and plaintiff's damages. *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 342 (2005) (loss causation element requires proof that issuer's stock price declined because of revelation of defendant's statement, omission or act); *see also* 15 U.S.C. § 78u-4(b)(4) ("plaintiff shall have the burden of proving that the *act or omission of the defendant* . . . caused the loss for which the plaintiff seeks to recover damages") (emphasis added).

Here, the Vendors did not make any actionable misstatements to investors—indeed, their conduct was unknown to the market. Accordingly, the Vendors' conduct, in contrast to Charter's allegedly subsequent misstatements, could not—and did not—in any way affect the market price for Charter securities. Because no "causal connection" existed between any decline in Charter's stock price and the Vendors' conduct, Petitioner cannot demonstrate loss causation as to the *Vendors'* alleged participation in the

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[3] The decision in *In re Dynegy, Inc. Securities Litigation*, 339 F. Supp. 2d 804 (S.D. Tex. 2004), illustrates a proper application of the "in connection with" requirement to the sort of "scheme" allegations Petitioner relies on here. *See id.* at 916 (plaintiff's allegations that Citigroup structured and funded transactions with Dynegy to conceal from Dynegy's balance sheet hundreds of millions of dollars in debt and to inflate Dynegy's reported income and cash flows did not satisfy the "in connection with" requirement "[b]ecause plaintiffs in this case do not allege any facts showing that *Citigroup's* allegedly manipulative and deceptive acts coincided with sales of Dynegy securities") (emphasis added).

purported scheme to defraud. Thus, Petitioner's "scheme" theory would read loss causation out of Section 10(b).

* * *

This Court's strict adherence to each of the requirements of a Section 10(b) claim is particularly important to *Amici* and their members. *Amici*'s members provide much of the funding and financial risk mitigation for thousands of publicly-traded companies, and thereby the Nation's economy as a whole, through hundreds of thousands of financial transactions. In many cases, these transactions inherently raise complex accounting and disclosure issues within the unique knowledge of the borrower or counterparty and its accountants. Yet, under Petitioner's open-ended theory, financial institutions would face the prospect of huge liability for the improper accounting or public disclosures of their borrowers and counterparties, without any participation in that accounting or disclosure.

B. Petitioner's "Auditor Deception" Allegations Cannot Cure Its Legally Flawed "Scheme" Theory.

Petitioner seeks to rely on allegations that the Vendors' conduct "deceived" Charter's auditors, who purportedly would have stopped Charter from perpetrating a fraud had the "sham" nature of the transactions been apparent to them. (*See* Pet. Br. 40.) These allegations cannot cure the fundamental flaws in Petitioner's "scheme" theory, because those allegations do not satisfy the essential elements of the Section 10(b) claim against the Vendors.

In the first place, any alleged "deception" of Charter's auditors by the Vendors amounts, at most, to "substantial assistance" of *Charter's* deception of its investors, *i.e.*, aiding and abetting. It is undisputed that Charter remained free—after the closing of Charter's transactions with the Vendors—to make full and accurate disclosure to its auditors and to account for and report the transactions properly. If Charter did not do so, it was only Charter and others involved in

Charter's accounting and financial reporting that "used or employed" a deceptive device to deceive investors with respect to those transactions.[4]

Section 10(b), as interpreted by the courts, provides a cause of action for defrauded *investors*. Allegations of deception that enable someone else to defraud investors—such as deception of an issuer's auditors—are not primary violations of Section 10(b). *See, e.g.*, *Filler* v. *Hanvit Bank*, Nos. 01 Civ. 9510, 02 Civ. 8251, 2003 WL 22110773, at *1, *2 (S.D.N.Y. Sept. 12, 2003) (secondary actors' alleged "false confirmations" to issuer's auditor that certain loans made to issuer were non-recourse were not a primary violation), *aff'd*, 156 Fed. Appx. 413 (2d Cir. 2005); *Lawyers Title Ins. Corp.* v. *United Am. Bank of Memphis*, 21 F. Supp. 2d 785, 799-801 (W.D. Tenn. 1998) (conduct of defendant bank that plaintiffs could not have relied on but which helped prevent primary violator's fraudulent scheme from being discovered constitutes aiding and abetting); *Wells Fargo Bank* v. *Arizona Laborers, Teamsters & Cement Masons Local No. 395 Pension Trust Fund*, 38 P.3d 12, 27 (Ariz. 2002) (bank's conduct preventing discovery of primary violator's fraudulent scheme constitutes aiding and abetting). Even the Ninth Circuit in *Simpson*—on which Petitioner relies for its "purpose and effect" test (Pet. Br. 32-33)—recognized that deception of an *auditor*—as opposed to investors—could not form the basis for primary Section 10(b) liability. *See Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040, 1043-44, 1052-53 (9th Cir. 2006).[5] If the law

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[4] As *Central Bank* made clear, Section 10(b) prohibits the use and employment of a deceptive device, not "giving aid to a person who commits a manipulative or deceptive act." 511 U.S. at 177.

[5] In *Simpson*, the court rejected allegations that a secondary actor committed a primary violation by (i) deliberately structuring transactions in a manner to keep Homestore's auditor from "recogniz[ing] that the revenue that Homestore recorded was related to a prior transaction funded

were otherwise, there would be no way to distinguish primary liability from aiding and abetting.

Petitioner cannot sustain its "scheme" theory by characterizing the Vendors' purported "deception" of Charter's auditors—allegedly backdating and otherwise falsifying certain transaction documents—as "conduct" or a misrepresentation or an omission.[6] Regardless of labeling, the Vendors' actions do not satisfy the elements of a Section 10(b) claim. *First*, the statements in these documents were never made publicly available or otherwise communicated to investors such that any investor could have *relied* on those statements. *Second*, the alleged deception of Charter's auditors occurred contemporaneously with the transactions and, therefore, such purported deception was not "in connection with" investors' subsequent purchases of Charter's securities. *Third*, the allegedly falsified documents were not disclosed to the market and, thus, could not have been the cause of any decline in Charter's stock price and any investor losses.

Indeed, Petitioner's theory concerning the Vendors' purported "deception" of Charter's auditors serves only to confirm that the Vendors did not commit a primary violation of Section 10(b). Petitioner concedes that Charter's "false financial statements . . . deceived investors" (Pet. Br. 38)—in

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by Homestore," and (ii) agreeing to conceal information regarding the circular nature of the transactions by documenting transactions in such a way as to "not alert [the auditor] to the nature of the round-trip transaction." 452 F.3d at 1043-44.

[6] In fact, the Vendors dealt only with Charter and had no dealings with Charter's auditors, with whom Charter dealt on its own. In any event, the Vendors owed Charter's auditors no duty to disclose information and, thus, the Vendors' purported nondisclosure of information to Charter's auditors cannot, as a matter of law, form the basis for primary liability. *See, e.g., Chiarella* v. *United States*, 445 U.S. 222, 235 (1980).

other words, that it was plaintiffs' reliance on Charter's statements that caused the alleged losses Petitioner seeks to recover in this case. Nonetheless, Petitioner claims that the Vendors are liable under a multi-step "buil[d] upon" theory, *i.e.*, the financial statements were "built upon" the deception of "Charter's auditors[, who] never would have acquiesced to the publication of those [financial statements]" had the auditors not been "deceived" by the Vendors' conduct. (*Id.* at 38, 40.) In maintaining that Charter's alleged fraud was "built upon" the Vendors' actions, Petitioner effectively concedes that the Vendors' actions, at most, aided and abetted Charter's primary violation and did not themselves constitute a primary violation.

II. IF ADOPTED, PETITIONER'S "SCHEME" THEORY WOULD ADVERSELY AFFECT OUR NATION'S FINANCIAL MARKETS.

This Court should not create an amorphous and subjective theory of potentially catastrophic liability that would impede the important functions of banks and other financial institutions in providing the financial fuel that drives our Nation's economy. By any measure, Petitioner's "scheme" theory would create great uncertainty for banks and other financial institutions. If this theory were adopted, plaintiffs' lawyers routinely could bring coercive class actions against such institutions seeking many millions, and often billions, in damages based solely on a bank's participation in lending and other financial transactions. In these circumstances, this Court should not overturn Congress's explicit decision in the PSLRA to entrust the responsibility for deciding when to prosecute alleged aiders and abettors of securities fraud to the expert judgment of the SEC.

A. Petitioner's Vague "Purpose and Effect" Test Cannot Be Rationally Administered and Would Lead to Arbitrary Results.

In support of its "purpose and effect" test, Petitioner tries to draw a distinction between "legitimate" and "illegitimate" transactions on which the question of primary liability would turn. (*See* Pet. Br. 6-8, 12, 14.)[7] Ignoring the statutory elements of a Section 10(b) claim, Petitioner proposes that banks and other secondary actors that engage in "legitimate" transactions with an intent to further a fraud are merely aiders and abettors, while those that engage in "illegitimate" transactions to further a fraud are primary violators. In proposing this standard, Petitioner makes no effort to define coherently "legitimate" or "illegitimate" transactions or to explain how federal judges around the Nation would apply this vague standard in deciding motions to dismiss and for summary judgment. On its face, such a test has no place in the law, much less in "'an area that demands certainty and predictability.'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988)). In application, Petitioner's proposed standard would "lead[] to the undesirable result of decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business." *Id.*

Making matters worse, Petitioner's ambiguous and fact-intensive standard would create a factual dispute in virtually every case, making it extremely difficult for innocent defendants to obtain dismissal of even the most dubious claims. Indeed, bi-partisan groups have recently concluded that this type of litigation uncertainty and risk is

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[7] One of Petitioner's *amici* goes even further, suggesting that liability turn upon whether the "business purpose" for the transaction is substantial or "insubstantial." (Br. of N.Y. State Teachers' Ret. Sys. et al., 12-13 n.6.)

severely damaging the competitiveness of the U.S. capital markets.[8]

In the face of years of litigation and the risk of massive damages at a trial, many banks and other financial services companies will have no choice but to abandon their defenses—regardless of the merits of those defenses—and to pay expensive settlements.[9] The risk of crippling jury awards means that "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit

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[8] For example, a bi-partisan commission recently formed by the U.S. Chamber of Commerce to study the current state of the U.S. capital markets concluded that the legal standard advocated by the Petitioner here would increase the cost of raising capital in the United States. COMM'N ON THE REGULATION OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 90-92 (Mar. 2007), *available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.htm.

[9] Congress has recognized that "basic economics" can force defendants to settle "meritless" class actions that have "only a five percent chance of success" if the defendants are unable to obtain early dismissal. S. REP. NO. 109-14, at 21 (2005), *as reprinted in* 2005 U.S.C.C.A.N. 3, 21; *see also* S. REP. NO. 104-98, at 7 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 686 (if the defendant "cannot win an early dismissal," simple economics "may dictate a settlement even if the defendant is relatively confident that it would prevail at trial") (quoting statement of former SEC Chairman Arthur Levitt). Studies confirm that virtually every securities fraud claim that survives a motion to dismiss is settled; few businesses can afford to risk a trial, regardless of the merits of the claim. *See* RICHARD PAINTER ET AL., PRIVATE SECURITIES LITIGATION REFORM ACT: A POST-ENRON ANALYSIS 7 (Federalist Soc'y for Law & Pub. Pol'y Studs. 2002) ("no case has been tried since the PSLRA went into effect: all have either been settled or dismissed"); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991); Patrick M. Garry et al., *The Irrationality of Shareholder Class Action Lawsuits*, 49 S.D. L. REV. 275, 287 n.98 (2004) (citing studies).

from being resolved against him by dismissal or summary judgment." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-40 (1975) (observing that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"); *accord Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1106 (1991) ("The issues would be hazy, their litigation protracted, and their resolution unreliable. Given a choice, we would reject any theory . . . that raised such prospects . . . ."). The threat of costly and disruptive discovery adds an additional "*in terrorem* increment" to the settlement value of even meritless claims. *Blue Chip Stamps*, 421 U.S. at 741. For that reason, this Court has repeatedly rejected open-ended rules of uncertain application that would make Section 10(b) cases "virtually impossible to dispose of prior to trial other than by settlement," "no matter how improbable the allegations." *Id.* at 742. Similarly, Congress sought to reduce the number of vexatious lawsuits in enacting the PSLRA.[10]

B. Petitioner's "Purpose and Effect" Test Would Deter Beneficial Economic Activity by Financial Services Companies.

Petitioner's "purpose and effect" test would subject nearly every form of business transaction, including normal

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[10] *See* S. REP. NO. 104-98, at 19 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 698 ("amending the 1934 Act to provide explicitly for aiding and abetting liability actions under Section 10(b) would be contrary to [the] goal of reducing meritless securities litigation."); 141 CONG. REC. S8896 (daily ed. June 22, 1995) (statement of Sen. Domenici) ("It is time that we stop vexatious securities litigation, and fix it we will."); *see also* H.R. REP. NO. 104-369, at 32 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 731 ("This Conference Report seeks to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation. This legislation implements needed procedural protections to discourage frivolous litigation.").

commercial lending and other financial transactions, to challenge in a securities fraud class action. Structured finance transactions and derivatives transactions, such as those engaged in by *Amici*'s members to meet the needs of their customers, would be particularly vulnerable to coercive litigation because of the complexity of such transactions.

Every day, the U.S. banking industry engages in a wide variety of activities that finance the spending and investment of large and small businesses and enable them to engage in risk mitigation. Such transactions take many forms, and they are often structured by the borrower to achieve the most beneficial legal, tax or accounting result—a practice that is both legitimate and commonplace. The dynamic nature of accounting, tax and other regulatory rules further contributes to the complexity of such transactions and the need for innovation, as companies seek to customize transactions to meet their unique needs through such "structured finance" transactions.

Structured finance is critically important to the strength and growth of our economy. In these transactions, a company satisfies its goal of receiving funds, while at the same time meeting various other objectives, including minimizing or altering its risks, affecting the manner in which an asset and/or debt will be held, and lowering the cost of capital and funding.[11]

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[11] *See Oversight of Investment Banks' Response to the Lessons of Enron: Hearing Before the Permanent Subcomm. of Investigations of the S. Comm. on Governmental Affairs*, 107th Cong. 120 (2002) (statement of Richard Spillenkothen, Federal Reserve, Director, Division of Banking Supervision and Regulation) [hereinafter Spillenkothen testimony] ("To the economy's benefit, the structured finance business has led to a lower cost of capital to businesses and consumers, which has helped fuel greater access to credit and longer term growth."); *id.* at 134 (statement of Annette Nazareth, SEC, Director, Division of Market Regulation (and now an SEC Commissioner)) ("Structured finance plays an important role

The U.S. banking industry also engages in a large volume of derivatives transactions each year. As of year-end 2006, U.S. banks held derivatives with a notional value of $131.5 trillion, while the notional value of derivatives outstanding globally amounted to $327.3 trillion.[12] The banking industry uses derivatives transactions to protect against risks to which banks and their customers are exposed, including interest-rate or foreign-exchange-rate movements and credit-default risks.

Many of these transactions are inherently complex and customized and present difficult accounting issues and judgments even for professional accountants.[13] Accountants and other professional advisors for large companies spend literally thousands of hours reviewing such transactions (and the issuer's financial statements) for the purpose of determining the issuer's compliance with tax, accounting and other legal obligations.

It is counterproductive, and contrary to Congress's intent and sound public policy, to expect financial institutions to police the accounting judgments of their public-company counterparties. Financial institutions generally are in no position to do so, and such institutions should not be subject

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in the modern business environment. When used properly, it can provide needed liquidity and funding sources, investment opportunities, and can facilitate risk dispersion.")

[12] OFFICE OF THE COMPTROLLER OF CURRENCY, OCC'S REPORT ON BANK DERIVATIVES ACTIVITIES, FOURTH QUARTER 2006 7, 9 (2006), *available at* http://www.occ.treas.gov/ftp/deriv/dq406.pdf; Int'l Swaps & Derivatives Ass'n, Summaries of Market Survey Results, http://www.isda.org/statistics/recent.html (last visited August 7, 2007).

[13] *See, e.g.*, Todd Davenport, *The Uneven Evolution of Accounting Standards*, AMERICAN BANKER, July 28, 2004, at 17 ("Derivatives is the kind of thing where even the people trying to do it right end up making honest mistakes because it can be just so immensely complicated.").

to coercive securities class actions if those judgments by their counterparties and their advisors turn out to be incorrect or subject to dispute.[14] But Petitioner's proposed standard would impose such a burden on banks and thus would deter, or at least sharply raise the cost of, derivatives and structured-finance transactions, significantly eliminating the benefits of such transactions for U.S. businesses.

These costs are wholly unwarranted, particularly because Congress in the PSLRA expressly authorized the SEC to bring enforcement actions against, and levy substantial fines on, aiders and abettors. In addition, the prospect of prosecutions and other actions by the Department of Justice, state attorneys general, and self-regulatory organizations such as the Financial Industry Regulatory Authority, provides another meaningful layer of deterrence against such conduct and penalties for misconduct that accrue to investors who have been harmed. In contrast, Section 10(b) suits often serve to enrich lawyers, while providing relatively little compensation for investors.[15] In these

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[14] *See* Spillenkothen Testimony, *supra* note 11, at 119 (stating that banks should not "be required to second guess their customer's accountants, tax or legal experts or police their customer's activities. Such an expectation would require, inappropriately, banking organizations to assume management responsibility for their customers, place potential legal liability on banking organizations that would compromise their ability to perform their role as financial intermediaries or threaten their safety and soundness, and place significant costs on banking organizations to audit the activities of their customers.").

[15] *See* John C. Coffee, Jr., *Reforming the Securities Class Action*, 106 COLUM. L. REV. 1534, 1538 (2006) ("Securities class actions essentially impose costs on public shareholders in order to compensate public shareholders. This is a circular process whose perverse effects are compounded by the twin facts that (a) public shareholders tend to be diversified (and thus are on both sides of the wealth transfer), and (b) on each such transfer a significant percentage of the transfer payment goes to lawyers and other agents."). Indeed, a study of 500 securities fraud class actions filed after passage of the PSLRA concluded that they destroyed

circumstances, this Court should not create a cause of action that would upset the policy judgment that Congress made in the PSLRA.

III. THE COMMON LAW DOES NOT SUPPORT PETITIONER'S "SCHEME" THEORY.

Several of Petitioner's *amici* try to support Petitioner's expansive reading of Section 10(b) by claiming that it is justified because the Vendors' conduct constituted actionable fraud at common law, which Congress sought to expand with the 1934 Act. (*See* Br. of N. Am. Sec. Administrators Ass'n, Inc. ("NASAA Br.") 7-8; Br. of Am. Ass'n for Justice ("AAJ Br.") 12-16, 18; Br. of Change To Win and the CtW Investment Group ("CTW Br.") 4-5, 12-13, 18-19.) These arguments are misplaced.

First, whatever the state of the common law in 1934, this Court has since authoritatively construed the meaning of Section 10(b) and determined that this statute does not reach conduct, such as the Vendors' conduct here, that constitutes aiding and abetting, a conclusion that Congress subsequently ratified in the PSLRA. In any event, Petitioner could not have recovered against the Vendors in an action for common law fraud; at most, the Vendors' conduct would have amounted to a common law aiding-and-abetting claim, which cannot be imported into Section 10(b).

This appeal to the purported common law antecedents of Section 10(b) is not new. Notably, Petitioner's *amici* today

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on average 3.5 percent of the equity value of the defendants, resulting in $25 billion in shareholder wealth being "wiped out just due to litigation." ANJAN V. THAKOR, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 14 (U.S. Chamber Institute for Legal Reform 2005), *available at* http://www.instituteforlegalreform.org/issues/docload.cfm?docId=857. By reducing the equity value of defendants, abusive securities fraud litigation results in lower capital investment, which in turn "has obvious implications for job creation and economic growth." *Id.*

invoke the same appeals to the common law in support of "scheme" liability that respondents in *Central Bank* unsuccessfully raised in trying to persuade this Court that Congress intended Section 10(b) to include a cause of action for aiding and abetting. Brief for Respondents at *15-17, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 407323. The only difference between the arguments advanced by respondents in *Central Bank* and the arguments of Petitioner's *amici* here with respect to common law "antecedents" is that the former used the phrase "aiding and abetting" and the latter use the word "scheme."

A. The Common Law Has No Bearing on the Interpretation of Section 10(b).

In passing the 1934 Act, Congress did not create or intend to create the private right of action the courts subsequently implied under Section 10(b). *See Blue Chip Stamps*, 421 U.S. at 729-30 (legislative history does not provide "any indication that Congress considered the problem of private suits under [Section 10(b)] at the time of its passage" and "there is no indication that the Commission in adopting Rule 10b-5 considered the question of private civil remedies under the provision"); *see also Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350, 358-59 (1991). Thus, Congress could not have intended to import the common law to construe a cause of action it did not create.

Because the private Section 10(b) cause of action is an implied right of action, reliance on tort principles for interpretation "is entirely misplaced." *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 568 (1979) (declining to recognize implied private right of action under Section 17(a) of the 1934 Act based on common law tort principles); *see also Central Bank*, 511 U.S. at 178, 184; *Pinter*, 486 U.S. at 649, 652 (construing Section 12 of the 1933 Act; rejecting plaintiffs' interpretation, which was "grounded in tort doctrine," finding "no congressional intent to incorporate tort

law doctrines"); *Virginia Bankshares*, 501 U.S. at 1110 (Scalia, J., concurring) (reliance on tort law inappropriate because "the federal cause of action at issue here was never enacted by Congress").

Reliance on common law is especially inappropriate where, as here, this Court has interpreted the statutory language in question. "[W]here the Supreme Court has authoritatively construed the pertinent language of the statute giving rise to the plaintiffs' cause of action, the common law meaning of that language is irrelevant." *Regents*, 482 F.3d at 389. As this Court noted in *Zandford*, Section 10(b) "must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b)." 535 U.S. at 820; *accord Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.").

B. "Scheme" Claims Would Amount to No More Than Aiding and Abetting or Conspiracy Claims at Common Law.

1. Common Law Fraud Requires Reliance by the Plaintiff on the Defendant's Misrepresentation.

Petitioner's fraud claims against the Vendors would have failed at common law in 1934 on one of the primary bases such claims fail under Section 10(b) today—lack of reliance.

The cause of action for "deceit," the predecessor to fraud at common law, was not an expansive one.[16] Indeed, as

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[16] *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 910 (5th ed. 2004). The common law elements of a cause of action for deceit were (1) a false representation of (2) material fact (3) knowingly made by the defendant for the purpose of inducing plaintiff to rely on it, (4) justifiable reliance by plaintiff and (5) resulting damages. *Id.*

Professors Loss and Seligman note, at common law, "[i]n effect, the charge of deceit . . . is an accusation of thievery." LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 911 (5th ed. 2004).

When Congress enacted the 1934 Act, the law of deceit was well-illustrated by the landmark English case of *Peek* v. *Gurney*, (1873) L.R. 6 H.L. 377. In that case, the House of Lords held that directors of a corporation were not liable for deceiving a plaintiff who relied on false representations made in a prospectus authored by those defendants because the directors had no dealings with plaintiff and did not intend that plaintiff rely on the representations in question, which were directed only at initial purchasers of the company's stock. In that decision, Lord Chelmsford, after an extensive review of precedent, explained the rule:

> It appears to me that there must be something to connect the directors making the representation with the party complaining that he has been deceived and injured by it; . . . . In all these cases the parties in one way or another are brought into direct communication; and in an action the misrepresentation would be properly alleged to have been made by the Defendant to the Plaintiff; . . . .

Id. at 399-400. Lord Colonsay similarly concluded that "in a case of this kind it is necessary to make out some direct connection between the directors and the party who alleges that he was deceived." *Id.* at 401.

Courts addressing fraud claims after *Peek* repeatedly cited and relied on that decision to reject claims that were not based on direct communications.[17] In order to recover, it was

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[17] *See, e.g., Hindman* v. *First Nat'l Bank of Louisville*, 112 F. 931, 942-43 (6th Cir. 1902) ("It has never been a ground of action that the defendant made a dishonest representation, and that the plaintiff relied

necessary for plaintiff to show, among other things, that the plaintiff relied on the defendant's misrepresentation. Because the plaintiffs did not rely (and could not rely) on anything the Vendors said or did, Petitioner's claim against the Vendors therefore would have failed at common law.

2. The Common Law Authorities Cited by Petitioner's *Amici* Do Not Support Its "Scheme" Theory.

Petitioner's *amici* cite numerous decisions in support of their argument that the Vendors would be liable at common law, but notably, *Peek* v. *Gurney* is not among them. Furthermore, their discussion of the case law is characterized by both a disregard of the pertinent facts and holdings and a preoccupation with *dicta* in those decisions, none of which in any event remotely resembles the facts alleged to create liability against the Vendors here. As this Court has noted, "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." *Blue Chip Stamps*, 421 U.S. at 744-45.

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upon it and sustained injury. . . . unless [the plaintiff is] able in one way or another to bring [himself] within the class of persons for whom the representation was intended."); *Merchants' Nat'l Bank* v. *Armstrong*, 65 F. 932, 939, 940 (C.C.S.D. Ohio 1895) ("That such a [false] representation was so made somewhere, at some time, to some person, by the persons sought to be charged, is not sufficient; it must be made to the person seeking to charge them."); *Dinsmore* v. *National Hardwood Co.*, 208 N.W. 701, 702, 703 (Mich. 1926) (plaintiff's fraud claim against defendant fails even though defendant knowingly made false representation on which plaintiff relied because plaintiff's injury "too remote") (quoting *Hindman*, 112 F. at 941); *Brackett* v. *Griswold*, 20 N.E. 376, 380, 381 (N.Y. 1889) ("In order to recover in an action for fraud and deceit the fraud and injury must be connected.")

Most of the decisions cited by Petitioner's *amici* involve a situation where the defendants themselves had direct dealings with the plaintiff and/or engaged in the fraudulent acts on which the plaintiff relied, causing plaintiff injury. *See, e.g., Pennebaker* v. *Kimble*, 269 P. 981, 984 (Or. 1928) (plaintiff dealt directly with defendants, whose conduct falsely represented facts on which plaintiff relied); *Crompton* v. *Beedle*, 75 A. 331, 332 (Vt. 1910) (defendant-purchaser defrauded plaintiff-seller of land parcel by affirmative representation that was incomplete and hence misleading); *Noved Realty Corp.* v. *A.A.P. Co.*, 293 N.Y.S. 336, 340-41 (App. Div. 1937) (to the same effect); *Stewart* v. *Wyoming Cattle-Ranche Co.*, 128 U.S. 383, 383-84 (1888) (same); *Laidlaw* v. *Organ*, 15 U.S. (2 Wheat.) 178, 185-90 (1817) (same). In other cases, defendants who did not have direct dealings with the plaintiff were held liable on agency principles. *See, e.g., Downey* v. *Finucane*, 98 N.E. 391, 393 (N.Y. 1912); *Purdum* v. *Edwards*, 141 A. 550, 553 (Md. 1928).[18]

Petitioner's *amici* also seek to rely on various common law doctrines that are inapposite, distorted, or, in one case, non-existent, in an attempt to excuse their inability to satisfy the reliance requirement of a common law fraud claim.

Misrepresentations by "Conduct." Some of Petitioner's *amici* argue that the Vendors may be liable because they made misrepresentations by "conduct." (*See* CTW Br. 14-17; *see also* AAJ Br. 14 (common law recognized "that fraud can be effected by conduct"); *id.* at 16-17 (citing RESTATEMENT (FIRST) OF TORTS §§ 525, 533

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[18] Petitioner does not contend that the Vendors could be liable because Charter was their agent, and in any event Congress enacted a specific provision in the 1934 Act to define the scope of secondary liability for a Section 10(b) violation. *See* 15 U.S.C. § 78t(a).

(1938).) This argument is a red herring. The Eighth Circuit did not hold, and *Amici* do not argue, that conduct cannot be the basis for a securities fraud claim. Rather, as the cases cited by Petitioner's *amici* demonstrate, the conduct at issue must *itself* deceive the plaintiff. *See, e.g., District Motor Co.* v. *Rodill*, 88 A.2d 489, 493-94 (D.C. 1952) (liability for turning back odometer of car to "represent" to plaintiff that car was newer than it was); *Salzman* v. *Maldaver*, 24 N.W.2d 161, 167 (Mich. 1946) (defendant-seller defrauded plaintiff-purchaser in sale of aluminum sheets by placing undamaged sheets on top of each bundle of corroded and damaged sheets and thereby deceiving plaintiff as to quality of aluminum); *Lindberg Cadillac Co.* v. *Aron*, 371 S.W.2d 651 (Mo. Ct. App. 1963) (defendant-seller defrauded plaintiff-purchaser in sale of car by painting over a crack in car's motor block).

Here, by contrast, Petitioner does not allege or contend that the Vendors' conduct *itself* deceived any investor. Rather, using the *Aron* decision by way of example, the Vendors' conduct cannot be compared to a car salesman painting over a crack to deceive the car buyer; at most, the Vendors' conduct is analogous to paint shops that sold the paint allegedly knowing that the salesman would use the paint for such a purpose. Or, in *Rodill*, the Vendors' conduct is equivalent to the car manufacturer that failed to install a tamper-proof lock on the odometer allegedly knowing that it was very likely that the odometer would be tampered with to deceive prospective purchasers.

Viewed most favorably to Petitioner, the Vendors' conduct here amounted to a representation that the transactions at issue occurred on a particular date and that the pricing increase for the set-top boxes sold to Charter was due to increased manufacturing costs.[19] It is undisputed that no

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[19] *Amicus* Change to Win's argument that the Vendors' conduct "amounted to an assertion regarding the financial condition of Charter

such misrepresentations were made to, or relied upon by, Petitioner and other investors. The purported misrepresentations on which plaintiffs relied concerned the reported financial condition of Charter, which misrepresentations were made by Charter, *not* the Vendors, and which required Charter's intervening application of accounting rules.

Certain of Petitioner's *amici* also cite Section 533 of the RESTATEMENT OF TORTS. (*See* AAJ Br. 17-18; Br. for *Amici Curiae* States of Arkansas et al. 24-26.) Section 533 has no bearing here because Charter's investors did not rely on any "information" furnished by the Vendors. (*Cf.* Br. for *Amici Curiae* States of Arkansas et al. 26 (positing that "relevant question is whether information supplied by the (anonymous) actor was relied upon by the public").) Rather, Petitioner alleges that the Vendors "backdated" and otherwise falsified transaction documentation that was not seen, or intended to be seen, by investors, but instead was for the purpose of deceiving Charter's auditors so as to enable Charter to misrepresent the cash flows and revenues associated with those transactions to its investors. This alleged pattern is easily distinguishable from the scenario described in Section 533, which, in addition to requiring reliance by the plaintiff (absent here), requires that the misrepresentation be "made to a third person for the purpose of having him repeat its terms or communicate its substance to" the plaintiff.

"*Liability for All Participants in a Fraud.*" Certain of Petitioner's *amici* claim that the Vendors would be liable for fraud at common law, because "the common law of fraud

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that was not in accordance with the truth" (CTW Br. at 16) is without any foundation. The alleged conduct of the Vendors could not have constituted such a "representation" even to Charter's auditors (the only ones alleged to have seen the documents in question), much less Charter's investors.

historically attached primary liability to all of the participants in a fraudulent scheme." (NASAA Br. 9.) But this argument completely fails to distinguish liability for engaging in fraud from liability for aiding and abetting or conspiring to commit such fraud.[20] Indeed, Petitioner's *amici* do not dispute that common law liability for aiding and abetting fraud predates the 1934 Act. *See, e.g., Hobbs* v. *Boatright*, 93 S.W. 934, 939-40 (Mo. 1906); *Virtue* v. *Creamery Package Mfg. Co.*, 142 N.W. 930, 939 (Minn. 1913) (those who "aid or abet" a tort are "jointly and severally liable therefor"); *White* v. *Moran*, 134 Ill. App. 480, 491-92 (App. Ct. 1907); *Judson* v. *Cook*, 11 Barb. 642, 644 (N.Y. Gen. Term 1852); *see also* RESTATEMENT (FIRST) OF TORTS § 876(b) (1939). In *Central Bank*, this Court made clear that aiding-and-abetting liability was not imported into Section 10(b) by Congress. 511 U.S. at 184-85.

Petitioner's *amici* simply do not distinguish between liability based on aiding and abetting and conspiracy and the liability of a primary wrongdoer, which among other things requires reliance. Thus, for example, in holding the defendant liable for aiding and abetting, the *Hobbs* court acknowledged that plaintiff could not establish a primary fraud claim against the alleged aider and abettor because, as here, the plaintiff could not prove reliance. 93 S.W. at 939.

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[20] Respondents in *Central Bank* and certain of its *amici* (as well as the SEC) made similar common law arguments to try and persuade the Court that Section 10(b) prohibited aiding and abetting, arguing that by 1934 common law liability for aiding and abetting was "well-established." *See* Brief for Respondents at *15, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 407323; Brief for the Securities and Exchange Commission as *Amicus Curiae* in Support of Respondents at *10, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 13006275; Brief of *Amicus Curiae* Trial Lawyers for Public Justice et al. in Support of Respondents at *13, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 13006270.

"Duty Not To Commit Fraud." One *amicus*, Change to Win, maintains that the Vendors' "fraudulent conduct amounted to a misrepresentation and concealment," and that the Vendors had a common law duty to refrain from such conduct because "one who acts inherits a duty to act nondeceptively." (CTW Br. 22; *see also id.* at 18-23.) Change to Win cites no authority for this proposition,[22] which directly contravenes *Central Bank*. Change to Win claims that a duty is not required to impose liability on the Vendors because "a duty to refrain from fraudulent conduct" suffices. (*Id.* at 22.)[23] Even putting aside the circular reasoning of this argument, neither the common law nor federal securities law imposes a duty of disclosure on the Vendors to *plaintiffs*, to whom the Vendors never communicated at all, whether through words or conduct.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed.

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[22] This is unsurprising, as the common law was to the contrary. *See, e.g.*, Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L. J. 227, 238-39 & n.46 (1933) ("Both in [common law] negligence and in deceit, the issue as to whether or not the defendant owed any duty to the particular plaintiff with respect to the representations is primary. . . . That issue has insulated a large class of persons involved on the seller's side in the sale of securities against misrepresentation suits by a large class of investors.") (citing cases).

[23] Change To Win purports to distinguish this Court's insider trading cases as cases involving "pure silence" rather than "conduct" because the trading activity is "not itself deceptive in nature." (CTW Br. 21-22 & n.20.) This distinction makes no sense. This Court has determined in those cases that the "conduct" of trading securities based on the possession of material, non-public information is "deceptive" only when it is done in violation of a fiduciary duty to disclose. *See, e.g.*, *Chiarella*, 445 U.S. at 230; *see also O'Hagan*, 521 U.S. at 660.

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC.,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC..,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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INTEREST OF THE *AMICUS CURIAE*[1]

For more than 100 years, the American Institute of Certified Public Accountants ("AICPA") has served as the national organization of the certified public accounting profession. The AICPA's nearly 340,000 members, all of whom are certified public accountants, provide accounting services to companies and individuals through firms of all sizes, and as solo practitioners. Its members also serve as employees of companies, and in the government and academia. Among the AICPA's most important roles is to promote and maintain high professional standards among its members. To this end, the AICPA has been a principal force in developing accounting and auditing standards, drafting model legislation, sponsoring educational programs, and issuing professional publications to improve the quality of the services provided by CPAs.

The AICPA has a strong interest in judicial decisions that affect the scope and bases of accountants' liability under the federal securities laws. Because they are seen as having "deep pockets" and may be among the few solvent parties remaining after a corporate collapse, CPAs provide attractive targets for securities fraud plaintiffs. To ensure that accountants can focus on serving clients rather than on defending against often baseless lawsuits, the AICPA has participated as *amicus curiae* in a wide variety of cases, including some of this Court's most significant securities fraud cases in each of the last four decades: *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007); *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336 (2005); *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994); *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988); and *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

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[1] The parties' letters of consent to the filing of this brief have been lodged with the Clerk. Pursuant to Rule 37.6 of the Rules of this Court, the AICPA states that no counsel for a party has authored this brief in whole or in part and that no person or entity, other than *amicus curiae*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief.

The Court's decision in *Central Bank*, holding that there is no private right of action for aiding and abetting a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, is of paramount importance to the accounting profession. CPAs are paradigmatic "secondary actors," who for many years were sued under Section 10(b) not because they had committed a manipulative or deceptive act, but on the theory that they had assisted those who had. *Central Bank* put an end to such private actions. Since then, however, the plaintiffs' class action bar has tried to revive in several different guises the very claims that *Central Bank* held were unavailable. This case is the culmination of that misbegotten project. Because it is of manifest importance to the nation's CPAs to preserve the important limitations that Congress placed on Section 10(b) and Rule 10b-5, the AICPA submits this *amicus* brief.

INTRODUCTION AND SUMMARY OF ARGUMENT

The existence of a private right of action for aiding and abetting a violation of Section 10(b) was first recognized in *Brennan* v. *Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), and quickly became an entrenched, albeit unwarranted, staple of federal securities case law. Section 10(b) aiding and abetting liability had both criminal and tort law antecedents. See Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637, 646-47 (1988). According to Learned Hand's influential formulation, criminal aiding and abetting requires that the defendant must "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." *United States* v. *Peoni*, 100 F.2d 401, 402 (2d Cir. 1938); cf. *Landy* v. *Fed. Deposit Ins. Corp.*, 486 F.2d 139, 163-64 (3d Cir. 1973) (applying *Peoni* to Section 10(b)). Similarly, the Restatement of Torts, cited by many courts in the pre-*Central Bank* era, states that a person is liable for the conduct of another if he "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or

encouragement to the other so to conduct himself." *Brennan*, 259 F. Supp. at 680 (quoting RESTATEMENT OF TORTS § 876); see *Fed. Deposit Ins. Corp.* v. *First Interstate Bank of Des Moines, N.A.*, 885 F.2d 423, 429-30 (8th Cir. 1989).

From these sources, a common law of aiding and abetting liability under Section 10(b) eventually took shape. As generally articulated, such liability had three basic elements: (1) a securities law violation by the primary violator; (2) "knowledge" of this violation by the putative aider and abettor; and (3) "substantial assistance" by the aider and abettor in achieving the primary violation. Bromberg & Lowenfels, *supra*, at 662. "Substantial assistance" could take many forms, including aiding in the preparation of misstatements, financing transactions, or executing transactions on behalf of the principal. *E.g., Cumis Ins. Society, Inc.* v. *E.F. Hutton & Co.*, 457 F. Supp. 1380, 1386 (S.D.N.Y. 1978); see Bromberg & Lowenfels, *supra*, at 701-39.

In 1994, this judge-made legal structure came crashing down when this Court held that "the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation." *Central Bank*, 511 U.S. at 177. In so holding, the Court recognized that some secondary actors – including those who had knowingly participated in fraudulent activity – might escape Section 10(b) liability. The Court nevertheless concluded that its decision was compelled by the "text and structure" of Section 10(b). *Id.* at 188.

In the wake of *Central Bank*, Congress was persuaded by the SEC to codify aiding and abetting in the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, but *only* for enforcement actions brought by the SEC itself. 15 U.S.C. § 78t(e). Like this Court, then, Congress made crystal clear that those who merely assist others in defrauding investors are not subject to private lawsuits under Section 10(b).

Central Bank left open the possibility that secondary actors "may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are

met." 511 U.S. at 191 (emphasis in original). Seizing that opening, the plaintiffs bar began to urge courts to liberalize the requirements for *primary* liability in an effort to revive, in a different guise, the very same aiding and abetting claims that *Central Bank* had foreclosed.

The present case illustrates that effort. Whereas *Central Bank* rejected as classic aiding and abetting such "secondary" activities as participating, enabling, facilitating, and advising, petitioner proposes to recharacterize the very same conduct as a "deceptive device or contrivance" under Section 10(b), or as either a "scheme to defraud" or as conduct "operat[ing] as a fraud or deceit" under Rule 10b-5. Such conduct, petitioner says, is a *primary* violation of the statute and the regulation (and not merely aiding and abetting), so long as it is undertaken with the "purpose and effect" of furthering the fraud.

These reformulations of ordinary aiding and abetting lack any grounding in the text of Section 10(b). As this Court's cases have made clear, Section 10(b) forbids *misstatements* (but only on the part of the person who actually *makes* the misstatement), *omissions* (but only by those who have a duty to disclose), and *manipulative conduct* (but only manipulations that, standing alone, mislead the market about the value of a security). Respondent is charged with none of these: It did not make the misstatement that allegedly deceived petitioner (Charter did so when it filed its financial statements); it did not make an actionable omission (as it had no duty toward petitioner); and its conduct was not a manipulation (since the transactions in which respondent engaged had no impact on the market unless and until Charter falsely accounted for them in its financial statements).

Petitioner's proposed reformulations are thus nothing but aiding and abetting in new bottles. Nor is it true that petitioner's "purpose and effect" test would separate *true* "primary liability" from mere aiding-and-abetting-style "primary liability." As we show below, that test is both unworkable and unwise.

Finally, permitting private actions to revive aiding-and-abetting liability under new labels would deter or raise the cost of professional services that are of great importance to the securities markets. When faced with the prospect of suit merely for rendering assistance to a company that might itself defraud investors, rational economic actors – such as certified public accountants – may choose to sit on the sidelines. And because of the enormous stakes of even modest-sized securities class actions, the professionals who *do* provide those services and *do* get sued will face "inordinate or hydraulic pressure" to settle before trial, regardless of the merits. *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001). The costs dwarf the benefits and should not be tolerated.

The Court should affirm the Eighth Circuit's decision.

ARGUMENT

I. WHERE INVESTORS ARE INJURED BY AN ISSUER'S FALSE FINANCIAL STATEMENTS, LIABILITY UNDER SECTION 10(b) EXTENDS ONLY TO THOSE PARTIES WHO ACTUALLY MADE THE MISSTATEMENT

Most shareholder class actions follow a common pattern. Investors allege that a company made a false statement concerning the company's financial condition, either in an annual report, a quarterly report, or perhaps through a press release or an interview with an executive. Frequently, the plaintiffs sue the company's auditor as well, alleging that the auditor made a material misstatement in an audit report that accompanied the company's financial statements. Invoking the fraud-on-the-market theory articulated in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), the plaintiffs argue that the misinformation artificially inflated the stock price, and that they were injured when the company's true financial condition was revealed. The plaintiffs seek damages under Section 10(b) for what they claim they lost on account of the fraud.

This case is typical. Petitioner, purportedly acting on behalf of all investors in the securities of Charter, alleges that Charter's public financial statements overstated the company's revenue and cash flow. Pet. Br. 3, 9. The false financial statements, according to petitioner, inflated the price of Charter's stock. *Id.* at 3. And when Charter revealed the true state of affairs and restated its financial statements, the market price of its securities declined and Charter's investors lost money. *Id.* at 9.

What makes the case noteworthy is not its fact pattern, but whom petitioner chose to sue. Not content to pursue the party that issued the financial statements, petitioner sought other deep pockets – specifically, two companies that entered into "phony" and "sham" transactions (Pet. Br. 3, 7), to which petitioner attributed part (but by no means all) of the errors in Charter's financial statements. Although the respondents are not alleged to have misstated their own financial statements – nor otherwise communicated in any way with the market regarding the transactions at issue – petitioners seek to hold them liable on the ground that respondents' *participation* in the underlying transactions makes them primarily liable under Section 10(b) for Charter's alleged misstatements.

Petitioner's argument contravenes the statutory text. If accepted, it would also revive, in only slightly different garb, the very liability theories rejected in *Central Bank*. For these reasons alone, the court of appeals should be affirmed.

A. Allowing A Misstatement Case To Be Recharacterized As A "Deceptive Conduct" Or "Scheme" Case Is Inconsistent With The Text Of Section 10(b) And With This Court's Decisions

1. This Court has long held that, to engage in "deception" under Section 10(b), one must make a "material misrepresentation or material failure to disclose." *Santa Fe Indus.* v. *Green*, 430 U.S. 462, 474 (1977). And in *Central Bank*, the Court squarely rejected the proposition that one can

be liable for a misrepresentation or failure to disclose merely by engaging in conduct that aids and abets that deception.

Petitioner and its *amici* seek to evade these limiting principles. Unhappy with the constraints imposed by the text of Section 10(b), petitioner and its *amici* urge the Court to focus instead on the text of Rule 10b-5. Pet. Br. 23-26; Brief of *Amici* States of Arkansas, New Jersey, *et al.* ("Sts. Br.") 2. Observing that the Rule proscribes any "device, scheme or artifice to defraud" (Rule 10b-5(a)), and any "act, practice, or course of business which operates * * * as a fraud or deceit" (Rule 10b-5(c)), petitioners contend that the Rule is broad enough to encompass the "scheme" or "deceptive conduct" they allege here after all. They argue that respondents' "acts," "schemes," and "practices" all violate the text of Rule 10b-5 – and thus Section 10(b) as well – *even though* respondents did not make the "material misrepresentation" (Charter's financial statements) that allegedly defrauded the market.

That attempt to leverage the language of Rule 10b-5 into a new private right of action fails, because it ignores the well-established principle that the text of Section 10(b), rather than that of the Rule, determines what conduct is prohibited. In *Central Bank*, the Supreme Court reiterated that "the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." 511 U.S. at 173. Determining the scope of the Rule therefore requires "close attention to the *statutory* text," *id.* at 169 (emphasis added), for "the language of the statute must control the interpretation of the Rule." *Santa Fe Indus.*, 430 U.S. at 472. The statute delimits the conduct proscribed, even if the Rule's language is susceptible of a more expansive interpretation. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976). Accordingly, any "scheme" or conduct "operat[ing] * * * as a fraud or deceit" must fit within – *not extend* – the statutory language.

Section 10(b) says nothing about "schemes" or "practices," but instead makes it unlawful for any person "to use or employ, in connection with the purchase or sale of any security * * * any

manipulative or deceptive device or contrivance * * *." 15 U.S.C. § 78j(b). In *Santa Fe Industries*, the Court explained that a plaintiff "states a cause of action under *any* part of Rule 10b-5 *only* if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute.'" 430 U.S. at 473-474 (emphases added). The Court then addressed the meaning of both of these crucial terms.

"'Manipulation' is 'virtually a term of art when used in connection with securities markets.' The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Id.* at 476 (quoting *Hochfelder*, 425 U.S. at 199). To be "manipulative" under Section 10(b), the defendant's conduct must "inject[] inaccurate information into the market or create[] a false impression of market activity." *GFL Advantage Fund, Ltd.* v. *Colkitt*, 272 F.3d 189, 205 (3d Cir. 2001) (internal quotations omitted). In other words, the manipulation must *itself* distort the market in a way that would mislead investors.

As for "deception," the Court in *Santa Fe Industries* held that, because "the complaint failed to allege a material misrepresentation or material failure to disclose," there was no allegation of "deceptive" conduct with the meaning of Section 10(b). 430 U.S. at 474. Accordingly, the deceptions proscribed by the statute – and thus by Rule 10b-5 – involve the dissemination of false information (or the failure to disseminate truthful information in the face of a duty to do so). *Central Bank* reaffirmed that basic understanding: "As in earlier cases considering conduct prohibited by §10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177.

Respondents' alleged conduct in this case falls into neither of those categories. Their actions plainly were not market "manipulations" that "artificially affect[ed] market activity," and petitioner does not contend otherwise. Neither was their

alleged conduct a "deception," because respondents did not make the "material misrepresentation or material failure to disclose" that petitioner contends defrauded the market. *Santa Fe Indus.*, 430 U.S. at 474, 476. According to petitioner, it was *Charter's financial statements* that defrauded investors. See, *e.g.*, Pet. Br. 21 (Defendants' conduct "cause[d] the publication of artificially inflated financial statements to investors"), *id.* at 40 ("transactions were reflected in Charter's financials"); Sts. Br. 13 ("The plaintiffs in this action claim that they were defrauded by Charter's false reports of revenues and cash flows.").

Petitioner argues (Br. 31) that "conduct" – unaccompanied by either a misstatement or a failure of a duty to disclose – can constitute a "deception" under the statute. But neither *SEC* v. *Zandford*, 535 U.S. 813 (2002), nor *United States* v. *O'Hagan*, 521 U.S. 642 (1997), on which petitioner relies, support such a broad proposition. In those cases, the defendant committed deception by misappropriating funds (*Zandford*) or confidential information (*O'Hagan*), *while fraudulently omitting to disclose the act in breach of a fiduciary duty.* In both cases, the Court made clear that it was the defendant's "material failure to disclose" that gave rise to liability for "deception." See *O'Hagan*, 521 U.S. at 660 ("deceptive nondisclosure is essential to the § 10(b) liability at issue"; "it was O'Hagan's failure to disclose * * * that made his conduct 'deceptive' within the meaning of § 10(b)") (alterations omitted); *Zandford*, 535 U.S. at 1906 n.4 (had Zandford merely "told his client he was stealing the client's assets * * * it would not [have] involve[d] a deceptive device or fraud").

This "failure to disclose" theory of deception is of no help to petitioners. First and foremost, petitioners do not claim that they were defrauded by respondents' (or by anyone's) non-disclosure; they allege that they were defrauded by Charter's false financial statements. And in any event, as *Zandford* and *O'Hagan* make clear, a failure to disclose a fraud may violate the statute *only* when the failure breaches a fiduciary duty to disclose. Notwithstanding the States' argument (Sts. Br. 19-22),

mere "participation" in a fraud does not by itself give rise to a freestanding duty to disclose the fraud to the public. If it did, *Central Bank* would have come out the other way. See *Chiarella* v. *United States*, 445 U.S. 222, 232-33 (1980) (reversing insider trading conviction under Section 10(b) because defendant was not party to an agency or other fiduciary relationship that gave rise to a duty to disclose).

At bottom this is a simple misstatement case. Charter's allegedly misleading financial statements are paradigmatic false statements actionable under Rule 10b-5(b). They are what the market relied upon in overvaluing Charter securities, and thus what petitioner relied on in deciding to invest. In contrast, the revenue-generating transactions between Charter and respondents merely "enabled" Charter's alleged deception (Pet. Br. i) by helping to establish background conditions against which the misstatements were made. By allegedly engaging in conduct that did not *itself* deceive investors (but merely made the issuer's misstatements easier to prepare), respondents' status is (at most) that of aiders and abettors. To allow the claims against respondents to proceed under a "scheme" theory would resurrect the very kind of liability precluded by *Central Bank* and would permit virtually anything that once constituted aiding and abetting to become actionable by relabeling it as a "scheme."

2. Subjecting respondents to liability under Rule 10b-5(a) or (c) would subvert not only the core holding of *Central Bank*, but also the reasoning the Court used to get there. The Court made clear that it was rejecting aiding and abetting liability in order to implement Section 10(b)'s reliance requirement:

> A plaintiff must show reliance on the defendant's misstatement or omission to recover under 10b-5. Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions.

511 U.S. at 180 (internal citation omitted). The decision not to read aiding and abetting liability into Section 10(b) thus sprung, at least in part, from the Court's unwillingness to allow a defendant to be held liable without a showing that its *own* actions induced the plaintiff to invest.

Yet the theory of liability propounded by petitioners and their *amici* here would have precisely that effect. As the court of appeals observed (Pet. App. 10a), petitioner purchased Charter securities in reliance on the company's alleged misstatements – not in reliance on the allegedly "phony" transactions in which respondents engaged. Allowing petitioners to recover against those defendants would undermine the bedrock requirement that reliance must be proven as to the actions or statements of each defendant individually. Accordingly, petitioners' notion (Pet. Br. 20) that a plaintiff who relies on a misstatement thereby relies on the actions of every party who played some antecedent role in helping that misstatement come into life is precisely what *Central Bank* rejected.

3. Section 10(b) makes it unlawful "[t]o *use or employ*" a deceptive device or contrivance in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b) (emphasis added). To "use" or "employ" a "deceptive device" means to "convert [it] to one's service," or "to avail oneself of" it. *Bailey* v. *United States*, 516 U.S. 137, 145 (1995). It follows that a party cannot be liable under the statute on the basis of a deceptive device that *somebody else* "convert[ed] to [his] service" or to which *somebody else* "avail[ed]" himself.

According to petitioner's own allegations, it was Charter's financial statements that misled investors. See, *e.g.*, Pet. Br. 21. And the only party that "used" or "employed" those financial statements was Charter itself, which published and filed them with the SEC. There is no credible argument – nor do petitioner or its *amici* so contend – that respondents "used" or "employed" Charter's financial statements.

Petitioner nevertheless urges that the inclusion of the word "indirectly" in Section 10(b) ("It shall be unlawful for any person, directly or *indirectly*, by the use of any means or instrumentality of interstate commerce or of the mails * * * to use or employ * * * any manipulative or deceptive device or contrivance * * *") means that "all those who engage in deceptive conduct" may be liable under Section 10(b), even if it is somebody else who defrauds the plaintiff. Pet. Br. 20. The States refine the argument, contending that Section 10(b) prohibits parties from "using another person as a 'conduit' to communicate false information to the market." Sts. Br. 22-29.

Even if the word "indirectly" modifies the phrase "use or employ" (as opposed to modifying the statute's jurisdictional clause), it does not deliver the result petitioner and its *amici* hope for. The cases cited in the States' brief stand for the unremarkable proposition that a defendant "cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties." Sts. Br. 23 (quoting *Cooper* v. *Pickett*, 137 F.3d 616, 624 (9th Cir. 1997)). It is true, of course, that a defendant who whispers his fraudulent misinformation to a "conduit," intending that the conduit will disseminate the information about the defendant (and on his behalf) is not insulated from Section 10(b) simply because he used an intermediary.

But petitioner wants the word "indirectly" to extend liability, as well, to someone who has at most facilitated somebody *else's* ability to make his *own* misstatement directly to the public. Under those circumstances, the facilitator cannot be said to have "indirectly" *made* a misstatement. To the contrary, "[a]llegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms * * * all fall within the prohibitive bar of *Central Bank*." *Shapiro* v. *Cantor*, 123 F.3d 717, 720 (2d Cir. 1997).

In this case, respondents did not enlist Charter to report false information about *respondents'* financial condition. Charter's financial statements did not disclose, for example, that

Charter had entered into an equipment-for-advertising deal with respondents that would result in respondents earning a certain amount of revenue. Charter's financial statements did not even mention the respondents, the transactions with respondents, or any other information about respondents. It therefore cannot be said that *respondents* were making a statement of any kind through the issuance of Charter's financial statements, whether "directly" or "indirectly." For the same reasons, auditors who merely consult with clients regarding the structure or reporting of transactions, are not liable under Section 10(b) – either directly or indirectly – in the event the company makes a public misstatement.

B. Petitioner's "Purpose And Effect" Test Does Not Successfully Distinguish Garden-Variety Aiding And Abetting From True "Primary Liability"

In an effort not to revive *all* classic aiding and abetting claims, petitioner proposes to charge as primary liability only conduct that is committed with the "purpose and effect" of creating a false appearance of material fact in furtherance of a scheme to defraud. The Ninth Circuit has already adopted a similar standard, holding that a defendant may be held liable as a primary violator under Section 10(b) if it engaged in conduct that "had the *principal* purpose and effect of creating a false appearance of fact in furtherance of the scheme." *Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) (emphasis added), *petition for cert. filed subnom. Calif. St. Teachers Ret. Sys.* v. *Homestore.com, Inc.*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560).

The purpose and effect test utterly fails to distinguish garden-variety aiding and abetting from primary liability. After all, aiding and abetting *presupposes* that the secondary participant had the same "purpose," and caused the same "effect," as the primary violator. Indeed, under pre-*Central Bank* case law, an alleged aider and abettor could be held liable only if he acted with the purpose and effect of helping someone else violate the securities laws. See *Schatz* v. *Rosenberg*, 943

F.2d 485, 496 (4th Cir. 1991) (aiding and abetting generally requires a "conscious and specific motivation to aid the fraud"); *Renovitch* v. *Kaufman*, 905 F.2d 1040, 1045-46 (7th Cir. 1990) (internal quotation omitted); *Edwards & Hanly* v. *Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 485 (2d Cir. 1979). And this is hardly surprising, since aiding and abetting under Section 10(b) derived from accomplice liability under the criminal law, under which the accomplice must have acted "with the knowledge and intention" of helping the principal commit the crime. *United States* v. *Sayetsitty*, 107 F.3d 1405, 1411 (9th Cir. 1997); see 1A FED. JURY PRAC. AND INSTR. § 18.01 (5th ed. 2000).

From the standpoint of investors in the securities markets, moreover, a transaction whose purpose is the creation of false revenues is entirely indistinguishable from one whose purpose is *not* to do so. Investors are no more deceived by the former than by the latter. In neither case can the transaction have *any* effect on the market unless and until a third party decides to record its proceeds in a misleading way. The purpose and effect test thus misses the true distinction between primary liability and aiding and abetting, which is that a primary defendant must be culpable – in the sense of actually defrauding investors or the market – based on its *own* actions, rather than as a result of the conduct or statements of someone else. The *purpose* of the transaction ("primary" or otherwise) simply does not provide a principled basis on which to distinguish actual violations of Section 10(b) from mere aiding and abetting.

Finally, a "purpose and effect" test would be exceeding difficult to apply: How do we know what the "purpose" of any particular transaction is? One of the reasons that this Court rejected aiding and abetting liability in *Central Bank* was that "the rules for determining * * * liability are unclear, in 'an area that demands certainty and predictability.'" 511 U.S. at 188, quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988). Such uncertainty and unpredictability "leads to the undesirable result of decisions 'made on an *ad hoc* basis, offering little predictive value' to those who provide services to participants in the

securities business." *Ibid.*, quoting *Pinter*, 486 U.S. at 652. This Court concluded that "such a shifting and highly fact-oriented disposition" was "not a satisfactory basis for a rule" governing the standards for 10b-5 actions. *Ibid.*, quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 755 (1975). The "purpose and effect" test suffers from the same deficiencies.

The Court should make clear that the "schemes" or "deceptive conduct" covered by Rules 10b-5(a) and (c) are those that *of their own accord* distort the market or deceive investors. Conduct that does so only because another party uses it to make a public misstatement is neither a manipulation nor a deception under the statute.

II. EXTENDING LIABILITY FOR FALSE STATEMENTS TO PERSONS WHO DID NOT MAKE THEM WOULD IMPAIR THE QUALITY OF FINANCIAL REPORTING BY PUBLIC COMPANIES

Before an accounting firm issues a report on a public company's financial statements, it must perform an audit, the elements of which are prescribed by an extensive body of rules and regulations. Only after completing the required steps does an auditor publicly attest to the sufficiency of the audit procedures and the quality of the company's financial statements. Accounting firms are well aware that their affirmative representations about the audits they perform and about the quality of their audit clients' financial statements – if false – can give rise to crippling liability under the federal securities laws. As a consequence, auditors have every incentive to carry out a rigorous audit – typically an expensive and laborious project – before affixing their firm's name to the audit report that accompanies the client's audited financial statements.

Under the "purpose and effect" test advocated by petitioner, however, an auditor who conducts a limited review of a client's *unaudited* filings or public statements, or provides informal advice about the structure of a pending transaction, is likely to

become a new target for class-action counsel carrying the banner of "scheme liability." And if auditors face the prospect of bet-the-firm litigation based on a peripheral connection to statements they have not made, and transactions they have not audited, every auditor's relationship with its public company clients will be changed for the worse. The inherent murkiness of a "purpose and effect" standard would make dismissal on the pleadings of even meritless claims sufficiently uncertain as to require auditors to raise the cost of such services, or even decline to perform them altogether. All of that would make the overall quality of financial reporting worse, not better.

The vagaries of Section 10(b) litigation are so great that the regime petitioners propose may well cause auditors to "act in ways that will avoid not simply conduct that the securities law forbids * * * but also a wide range of * * * conduct that the securities law permits or encourages." *Credit Suisse Securities (USA) LLC* v. *Billing*, 127 S. Ct. 2383, 2396 (2007).[2] As a result, rational auditors may conclude that the safest course is to have nothing to do with any transaction or statement by a public company that has not been subjected to a formal audit. And the burden of that chilling effect would fall most heavily on the smaller and newer companies, as well as those operating in volatile industries such as technology, that have the greatest need for the types of services most likely to be branded as "schemes" by plaintiffs' lawyers. The rule petitioners propose would invite a new generation of claims that carry the threat of limitless liability. The Court should not issue that invitation.

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[2] See S. Rep. No. 104-98, at 9 (1995) (noting that "[u]nderwriters" and "other professionals are prime targets of abusive securities lawsuits" and that "[t]he deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant").

A. The Open-Ended "Purpose And Effect" Test Would Dissuade Auditors From Performing Services That Are Beneficial To Public Companies And Their Investors

1. The annual financial statements that every public company files with the SEC must be audited by a certified public accountant. See 15 U.S.C. § 78j-1 (mandating and setting standards for annual audit). An "audit" is a term of art, and its performance, from conception to completion, is governed by an extensive body of detailed requirements. The subject of the audit – the company's annual financial statements – must be prepared by the company in accordance with an equally detailed set of requirements. In most cases, after the auditor completes the audit, it issues an audit report, in which it makes two very specific public statements, one about the audit, and one about the audited financial statements.

First (in the case of domestic public companies), the auditor represents that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB").[3] Second, in the event an "unqualified" opinion is warranted, the auditor represents that the audit provides a "reasonable basis" on which to opine that the financial statements "present fairly, in all material respects, the financial position of [the] company," and "the results of its operations and its cash flows for the years then ended in conformity with" Generally Accepted Accounting Principles (GAAP).

Courts have long held that both portions of the audit report are "statements" for purposes of Section 10(b), and that either statement, if knowingly false (and if all the other requirements of Section 10(b) are satisfied), may be actionable in a private securities action. See, *e.g.*, *Lattanzio* v. *Deloitte & Touche LLP*, 476 F.3d 147, 153 (2d Cir. 2007). Indeed, it is only

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[3] The PCAOB has effectively adopted the Generally Accepted Auditing Standards (sometimes known as GAAS) promulgated by the AICPA.

through the act of issuing an opinion on the company's financial statements that "the independent auditor assumes a *public* responsibility transcending any employment relationship with the client." See *United States* v. *Arthur Young & Co.*, 465 U.S. 805, 817 (1984) (emphasis in original). It is precisely because of the practical and legal significance of the audit report that audits of large public companies are typically such laborious and expensive undertakings. Understandably, auditors are (and should be) unwilling to affix their firm's name to an audit report without first having carried out the steps that the PCAOB prescribes.

2. But a financial statement audit is not the only important task that auditors perform for their public company clients. Auditors commonly render a variety of other services that do *not* require the planning and performance of a formal audit, and that do *not* culminate in the issuance of a publicly filed statement by the auditor.

For example, auditors typically perform a "review" of their client's quarterly, or interim, financial statements – a procedure that is far more limited in scope than an audit of the annual financial statements. See 17 C.F.R. § 210.10(d) (mandating review); Statement on Auditing Standards ("SAS") 100 (setting out standards for review). Unlike an audit, a review is designed for the limited purpose of communicating to the client whether the auditor has become aware of any "material modifications" that should be made to the financial statements in order to comply with GAAP. D. R. CARMICHAEL, O. RAY WHITTINGTON & LYNFORD GRAHAM, ACCOUNTANTS' HANDBOOK, § 15.5(b) (11th ed. 2007) (hereinafter "ACCOUNTANTS' HANDBOOK"); see also, MICHAEL J. RAMOS, PRACTITIONER'S GUIDE TO GAAS at 549 (2006) (hereinafter "PRACTITIONER'S GUIDE"). Significantly, federal regulations are clear that an accountant is not required to file a report with quarterly financial statements. See 17 C.F.R. § 210.10(d).[4]

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[4] Under the federal regulations, an auditor must issue a report *only* if

Since *Central Bank*, courts have consistently rejected attempts by class action counsel to sue auditors on the basis of alleged misstatements in their clients' unaudited quarterly filings. See *Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *In re IKON Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 685 n.5 (E.D. Pa. 2001); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp 26, 28 (D. Mass. 1994); *In re Seracare Life Sciences, Inc. Sec. Litig.*, No. 05-CV-2335-H (CAB), 2007 WL 935583, at *10 (S.D. Cal. Mar. 19, 2007).

Under the expansive liability regime advocated by petitioner, however, it would be a simple matter for inventive plaintiffs' counsel to extend Section 10(b) liability to auditors on the basis of unaudited statements. First, counsel would assert that the company fraudulently accounted for some transaction in its quarterly financial statements. Next, counsel would allege that the company's auditor knowingly overlooked or approved of the fraud during the quarterly review, all with the "purpose and effect" of enabling the fraudulent "scheme." Experience teaches that the heightened pleading requirements of the PSLRA would be cold comfort in the face of such claims; if auditors were exposed to liability based on their clients' unaudited financial statements, they would be well advised to perform the procedures associated with an *audit* every quarter.[5]

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the interim financial statements explicitly refer to the auditor's review. See 17 C.F.R. § 210.10(d). And, even when a report is filed in connection with a quarterly financial statement, that report does not give a positive assurance that the statements comply with GAAP, as does an audit opinion. Instead, the report provides only the negative assurance that the auditor is not aware of any material modifications that should be made to the financial statements. See PRACTITIONER'S GUIDE at 563-64.

[5] The quarterly review function, though more limited in scope than an audit, serves a valuable purposed. The review "is procedurally integrated into the company's year-end audit and thereby tends to reduce sharp variations and year-end surprises by spreading

3. The expansive liability that petitioners propose also would encourage plaintiffs' counsel to sue auditors based on contacts that are even less involved than a quarterly review. Throughout the year, public companies consult with auditors to discuss the accounting ramifications of various business decisions. Auditors often attend meetings to discuss potential transactions. Such interaction assists the client in understanding how the transaction will affect its financial statements and helps the client determine whether to do the transaction and how it should be structured. Similarly, auditors often respond to telephone inquiries from clients requesting advice on the accounting treatment of proposed business decisions.

But if auditors may be subject to suit based on allegations that even the briefest conversation was part of a scheme to defraud, they may hesitate to interact with the client until the performance of year-end audit procedures. This would be a disservice to both the client and its shareholders. The client may well refrain from entering into a transaction or making a strategic business move if it does not have any guidance as to the accounting implications of its decision. And, if the company does take action but initially accounts for it incorrectly, there will be larger corrections – or "year-end surprises" (*Lattanzio*, 476 F.3d at 156) – in the annual financial statements.

4. Finally, audit firms also provide advice to non-audit clients. A company may seek a second opinion from an accounting firm that is not its auditor on the accounting treatment for a proposed transaction that raises novel or undecided accounting issues. This kind of engagement, which is recognized by the accounting literature,[6] allows issuers to

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corrections throughout the year." *Lattanzio*, 476 F.3d at 156 (citing Professionals Issues Task Practice Alert 2000-4, *Quality Review Procedures for Public Companies*).

[6] SAS 50, as amended by SAS 97, governs the issuance of letters addressing proposed transactions to non-audit clients.

consider numerous alternatives for reporting on new and emerging issues. PRACTITIONER'S GUIDE at 494. Again, however, adoption of "purpose and effect" scheme liability would be seized upon by the plaintiffs' bar as a basis for alleging that the advice had the "purpose and effect" of falsifying the company's financial statements. In that world, firms could be expected to refuse these engagements.

5. Once liability for deception under Section 10(b) is untethered from any requirement that the defendant make a public misstatement, there will be a chilling effect on the performance by auditors of services that are beneficial to companies and their shareholders. In the years immediately preceding passage of the PSLRA, it was well documented that rampant class action litigation against CPAs made accounting firms increasingly unwilling to perform audits for clients perceived as risky, such as those in financial distress, smaller or less-well established companies (including start-ups), and companies operating in volatile industries such as technology. See Frederick L. Jones & K. Raghunandan, *Client Risk and Recent Changes in the Market for Audit Services*, 17 J. ACCT. & PUB. POL'Y 169, 179 (1998).

A shrinking supply forces companies with fewer resources to absorb higher prices for legally required financial audits.[7] Such high-risk firms are particularly dependent upon the imprimatur of a well-established, well-respected auditor in order to gain the confidence of the market. Depriving them of quality auditing services makes it more difficult for the growth sectors of the economy to develop to their full potential. *Central Bank*, 511 U.S. at 189. For, even where litigation risk does not cause CPAs to forego providing professional services, they will typically insist on higher fees to high-risk clients,

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[7] Audit fees for Fortune 500 companies increased by more than 100% from 2001 to 2004. See Jack T. Ciesielski & Thomas R. Weinrich, *Ups and Downs of Audit Fees Since the Sarbanes-Oxley Act*, THE CPA JOURNAL (October 2006) (reprinted at www.nysscpa.org/-printversions/cpaj/2006/1006/p28.htm).

costs that the client companies will undoubtedly attempt to pass on to consumers. See Jamie Pratt & James D. Stice, *The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Fees*, 69 ACCT. REV. 639, 655 (1994).

B. Auditors Are Especially Vulnerable To Vexatious Securities Class Actions, And Thus Stand To Be Disproportionately Harmed By The Rule Advocated By Petitioner

Auditors are particularly attractive targets in securities class actions for a number of reasons. First, application of the conventions, rules, and procedures that collectively constitute accepted accounting practices requires substantial professional judgment. "[A]uditing is not a mechanical process, and an audit report is not an objective statement of fact." Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17, 54 (2003).[8] And, GAAP is not "a canonical set of rules that will ensure identical accounting treatment of identical transactions," but instead "tolerate[s] a range of 'reasonable' treatments * * *." *Thor Power Tool Co.* v. *Commissioner of Internal Revenue*, 439 U.S. 522, 544 (1979).

An "expectations gap" therefore persists between what CPAs expect of their work and what the public (and often the courts) expect. See Richard I. Miller & Michael R. Young, *Financial Reporting and Risk Management in the 21st Century*,

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[8] An audit is designed to provide a *reasonable* basis for the auditor to express an opinion on the client's financial statements taken as a whole. ACCOUNTANTS' HANDBOOK § 15.5 at 16. (emphasis added). An "audit does not guarantee that a client's accounts and financial statements are correct any more than a sanguine medical diagnosis guarantees well-being; indeed, even an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect material omission or misstatement." *In re IKON Office Solutions, Inc.*, 277 F.3d 658, 673 (3d Cir. 2002).

65 FORDHAM L. REV. 1987, 2016 & n.129 (1997). This gap contributes to an environment in which investors are likely to blame auditors for unforseen corporate collapses and to sue them when they occur. The allegation that a CPA ran afoul of some aspect of the general rules of GAAS or failed to identify one of the myriad potential GAAP violations is easy to make and difficult to rebut. Courts routinely invoke such alleged violations in sustaining claims against auditors. See, *e.g.*, *Rhode Island Hosp. Trust Nat'l Bank* v. *Swartz*, 455 F.2d 847, 852 (4th Cir. 1972); *In re Ancor Communications, Inc.*, 22 F. Supp. 2d 999, 1005-06 (D. Minn. 1998); *In re Miller Indus., Inc. Sec. Litig.*, 12 F. Supp. 2d 1323, 1332 (N.D. Ga. 1998). Especially in a declining market, where the bursting of a bubble leaves many investors with significant losses, bringing suit against an auditing firm based on an allegedly deficient audit can be an easy way to try to recoup those losses.

Second, CPAs are inviting, "deep pocket" targets for expansive notions of securities fraud liability. In the wake of a corporate failure, the auditor is often the last one standing. In many cases, the issuer responsible for the allegedly misleading financial statements has gone bankrupt or become otherwise judgment-proof, leaving the CPA as the only entity from which plaintiffs can hope to recover their investment losses. See Daniel L. Brockett, *Line Between Primary and Secondary Liability Still Blurred in Securities Cases*, 50 FED. LAW. 29, 30 (2003). Indeed, between 30 and 40 percent of securities fraud cases against auditors involve companies that are in, or about to enter, bankruptcy. See Zoe-Vonna Palmorose, *Who Got Sued?* J. OF ACCOUNTANCY ONLINE (March 1997), available at www.aicpa.org/pubs/jofa/march97/whosued.htm. Thus, despite having played only a secondary role – that may consist of little more than reviewing allegedly misleading financial statements, or merely answering an accounting question on a quick phone call – accounting firms frequently emerge as the lone defendant financially able to satisfy a potential judgment. See Feinman, 31 FLA. ST. U. L. REV. at 57.

Given their exposure to potentially vast liability, as well as their concern for their professional reputations, accounting firms may be forced to settle even where the merits of a suit are dubious. Against this backdrop, confining "deception" liability only to those defendants who actually *made* a deceptive misstatement guards against the prospect that auditors will be made to cover investment losses for which their actions were not in fact responsible. Conversely, expanding Section 10(b) liability in the manner petitioner suggests would move the securities laws closer to what they were never intended to be: a form of cost-free insurance for disappointed investors. See *Dura Pharmaceuticals*, 544 U.S. at 344.

Failure to adhere to the statutory text – thereby opening the door to a new wave of lawyer-driven litigation – would have serious consequences for the already-beleaguered accounting profession. Securities litigation is extremely costly, *regardless* whether the underlying claim has the slightest merit. One study found that it costs an auditor an average of $3.7 million to defend itself against even a weak securities fraud class action. See Palmrose, *supra*.

Class action litigation against accounting firms did decrease in the first years after passage of the PSLRA, a trend undoubtedly helped by this Court's holding in *Central Bank*. See SEC, Office of the Gen. Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 22 (Apr. 1997), available at www.sec.gov/news/studies/lreform.txt. More recently, however, there has been a resurgence in litigation alleging accounting fraud and targeting CPAs. In 2006, accounting-related cases represented 60 percent of all private securities class actions, up from 48 percent in 1996. PricewaterhouseCoopers LLP, *2006 Securities Litigation Survey*, at 8-9. Accounting-related settlements represented the majority of the largest securities fraud settlements, totaling 93 percent of all securities-related settlement amounts in 2006. *Id.* at 31-33. It has thus been accurately observed that accounting fraud seems to have become "the 'complaint of choice' for

private securities class action plaintiffs." Pricewaterhouse-Coopers LLP, *2002 Securities Litigation Survey*, at 4.

Empirical studies have also shown that litigation against an audit firm – even, or perhaps especially, frivolous ligation – hurts the stock price of an auditor's *other* clients. See Diana R. Franz, et al., *The Impact of Litigation Against an Audit Firm on the Market Value of Nonlitigating Clients*, 13 J. ACCT. AUDITING & FIN. 117 (1998).

Finally, the expansive – and non-textual – construction of Section 10(b) advocated by petitioner is all cost and no benefit: There is simply no reason to fear that rejecting "purpose and effect" liability will somehow create a gap in the enforcement of the securities laws. The SEC is authorized to bring enforcement actions against aiders-and-abettors. See 15 U.S.C. § 78t(e). The federal government thus always retains the power to take action against individuals and firms that knowingly and substantially assist fraud proscribed by the federal securities statutes, regardless of whether any particular investors suffered financial harm as a result of that fraud. There is neither need nor reason to extend that expansive law enforcement power to private plaintiffs. To the contrary, doing so could effectively delegate wide-ranging enforcement power to unaccountable plaintiffs' lawyers, trenching on the SEC's prosecutorial discretion.

The States miss the mark when they argue (at 8) that private litigation is necessary to supplement SEC enforcement actions. Although it has been noted that, in certain circumstances, private lawsuits serve a valuable role, Congress was explicitly asked to reverse *Central Bank* with regard to both private plaintiffs and the SEC. See S. Rep. No. 104-98, at 48-49 (1995). Congress elected to restore such liability *only* when the SEC is the plaintiff. See 15 U.S.C. § 78t(e). Petitioner should not be permitted to circumvent Congress' judgment by slapping a new name on aiding and abetting cases.

CONCLUSION

For the foregoing reasons, the judgment of the Eighth Circuit should be affirmed.

Respectfully submitted.

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In The Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

BRIEF OF *AMICI CURIAE* AMERICAN INSURANCE ASSOCIATION AND PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*[1]

The American Insurance Association ("AIA") and the Property Casualty Insurers Association of America ("PCI") are the major national associations of property and casualty ("P&C") insurance companies. AIA and PCI members collectively write a great majority of the P&C insurance market in the United States, including all types of commercial and personal lines of business. AIA and PCI members, ranging in size from the largest multinational insurers writing business in all states and globally to small insurers writing business in one state or region, include companies doing business as publicly traded stock companies and mutual companies. AIA and PCI seek to promote a healthy and competitive P&C insurance marketplace through advocacy before federal and state policymakers and participation as *amici* in cases that are significant to the P&C insurance industry.

AIA and PCI have a keen interest in the outcome of this case because reversal of the decision below could adversely affect the cost and availability of insurance for businesses and the cost of services from outside vendors with whom insurers contract. It could also threaten unreasonably insurers' obligations to maintain the confidentiality of information collected in the normal course of business about their publicly traded insureds.

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[1] Counsel for a party has not authored this brief in whole or in part, and no person or entity, other than *amici curiae* or their counsel, has made a monetary contribution to the preparation or submission of this brief. Respondents have consented by letter (attached) to the filing of this brief, and Petitioner's letter of consent is on file with the Court.

SUMMARY OF ARGUMENT

In *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), this Court held that a securities fraud plaintiff does not have a civil cause of action under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the Securities and Exchange Commission's implementing regulation, Rule 10b-5, 17 C.F.R. § 240.10b-5, against one who aids and abets a section 10(b) violation. Petitioner and its supporting *amici* seek to relitigate that ruling *sub silentio*, or at least to limit it, by essentially arguing that some aiders and abettors (or, as some *amici* argue, all knowing participants) are liable as primary violators when there is a scheme to defraud. That approach would effectively overrule *Central Bank* in many securities cases.

Whatever a plaintiff's theory of liability, *Central Bank* requires the courts to dismiss parties who are solely aiders and abettors (*i.e.*, those who are solicited by the primary violators to assist in the scheme), even where, as here, the plaintiff alleges that a number of defendants participated in a "scheme to defraud."

Allowing a private action against all parties who are alleged to be knowing participants in a scheme to defraud, including those who "substantially assist" the primary violators – the test for aiding and abetting liability – would have a serious negative impact on the insurance industry. It would expose a whole new class of financial institutions to expensive litigation and potentially extortionate class action settlement demands. And significantly, it would adversely affect property and casualty insurance companies and markets. The result would be higher premiums for insureds, potentially putting adequate

coverage outside the reach of many businesses, particularly those that are small or mid-size or in higher-risk industries. Moreover, it would leave insurers unclear about their duties to disclose to the Government or to the public information regarding their publicly traded insureds.

ARGUMENT

I. PETITIONER IMPROPERLY SEEKS TO EXTEND LIABILITY UNDER SECTION 10(b) WHENEVER A "SCHEME TO DEFRAUD" IS ALLEGED TO THOSE WHO, AT MOST, HAVE SOLELY AIDED AND ABETTED A SECURITIES VIOLATION.

Central Bank holds that "there is no private aiding and abetting liability under § 10(b)." *Central Bank*, 511 U.S. at 191. Petitioner does not contest that, Brief for Petitioner at 14-15, and the question on which certiorari was granted does not request – at least explicitly – that the Court overrule *Central Bank*.

In an effort to avoid *Central Bank*, Petitioner and several *amici* supporting it propose that as long as there is a "scheme to defraud," *Central Bank* does not apply. Some *amici* go so far as to argue that all participants in the scheme are liable in a private civil action. But *Central Bank* itself involved an alleged scheme to defraud. Thus, reversal of the decision below would effectively overrule *Central Bank* in many if not most securities cases, since a creative plaintiff's lawyer could almost always allege a "scheme" to defraud.

By definition, an aider and abettor knowingly provides substantial assistance to the perpetration of a primary violator's scheme to defraud. *See* 15 U.S.C. § 78t(e) ("persons who aid and abet" are those "that knowingly provide[] substantial assistance to another person in violation of [Title 15]"); *see also, e.g., Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir.) (aiding and abetting requires, *inter alia*, "that the aider-abettor knowingly and substantially participated in the wrongdoing"), *petition for cert. denied sub nom. First Pennsylvania Bank v. Monsen*, 439 U.S. 930 (1978). The existence of a scheme does not negate the applicability of the holding in *Central Bank*, or the reasons for the holding, that aiders and abettors are not liable in a private civil action under section 10(b). *See Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006) (recognizing use of "scheme to defraud" as basis for primary liability, but affirming dismissal of complaint because it failed to allege primary liability), *petition for cert. filed*, 75 U.S.L.W. 1030 (U.S. Oct. 19, 2006) (No. 06-560).

The test for primary liability under section 10(b) which Petitioner and its *amici* propose is too broad. To do as Petitioner asks would require the Court to overrule *Central Bank*, at least in large part, thereby creating an artificial distinction between two types of securities cases: those where a scheme to defraud is alleged, and those where the alleged misrepresentation (or omission) is not part of a "scheme to defraud." One is hard put to imagine a case fitting only the latter category.

II. THE RELITIGATION OF *CENTRAL BANK* SOUGHT BY PETITIONER THREATENS TO DISRUPT INSURANCE MARKETS AND THE RELATIONSHIPS BETWEEN INSURERS AND THEIR COMMERCIAL POLICYHOLDERS AND VENDORS.

The policy arguments made in support of Petitioner's position make clear that those arguments are a thinly-veiled attempt to relitigate *Central Bank*. *See*, *e.g.*, Brief of the North American Securities Administrators Association, Inc. as *Amicus Curiae* in Support of Petitioner at 4-5 ("A decision that holds *all* parties accountable for their role in a fraudulent scheme . . . will help repair the damage done to investors and deter future violations") (emphasis added); Brief of AARP, Consumer Federation of America, and U.S. PIRG as *Amici Curiae* in Support of Petitioner ("AARP Brief") at 4 ("Investors in major securities fraud cases will often be denied a remedy for their losses when outside actors are not held liable for violating § 10(b) . . . ").[2] In *Central Bank*, the Court considered and rejected the exact same policy arguments. *Central Bank*, 511 U.S. at 188 (noting that the SEC's policy arguments in support of a Rule 10b-5 aiding and abetting cause of action included "deter[ring] secondary actors from contributing to fraudulent activities and ensur[ing] that defrauded plaintiffs are made whole"). As the Court there stated, "[p]olicy

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[2] Other policy arguments are directed toward the issue of whether "deceptive devices" that are actionable under section 10(b) should include "schemes to defraud." *See* Brief for Petitioner at 34-36. As discussed, *supra* at 3-4, even if a scheme to defraud is actionable under section 10(b), the propriety of Petitioner's claims against Respondents turns on whether Respondents were primary movers in the scheme, or instead were aiders and abettors.

considerations cannot override our interpretation of the text and structure of the Act. . . . " *Id.*

Were the Court to allow private actions against parties who substantially assist another's scheme to defraud, companies will become potential defendants any time they do business with a publicly held entity that is later sued for securities fraud as long as plaintiffs allege knowledge of the scheme. The result urged by Petitioner would create new and uncertain duties for any business that contracts with a publicly traded company. That includes insurers.

Insurers, who must invest premiums to back obligations to policyholders, are among the largest investors in equities in the nation. As a result, the insurance industry is second to none in fostering appropriate safeguards to assure the protection of investors, sound corporate governance, and ethical business practices. Nevertheless, unique aspects of the property and casualty insurance industry would make those insurers prime targets of securities class action litigation under Petitioner's broad theory of scheme liability.

The most immediate impact on the insurance industry would be to dramatically increase the exposure of insurers that issue directors and officers liability policies ("D&O policies"), which often provide coverage for securities claims. That would inevitably increase the premiums for those policies. Not only would insurers be subject to expanded claims for losses related to coverage for securities lawsuits, but, where appropriate, they would have to defend against the claims brought against alleged insured aiders and abettors as well as against the alleged insured

primary violators who conceived and executed the claimed scheme.

The great majority of class action lawsuits are never tried because defense costs in those cases are substantial. As *amici* AARP, *et al.*, argue, "defense costs in securities fraud cases often quickly exhaust" the D&O coverage available (AARP Brief at 11-12), even though "[m]ost large U.S. companies carry D&O policies with coverage limits of between $100 and $200 million. . . ." *Id.* at 11. Thus, defendants often settle to escape the ruinous costs of defense. The result is that, "[w]hile D&O policies fund much of the plaintiffs' and class members' recovery in garden-variety fraud cases, they do the victims of major frauds involving insolvent stock issuers little good in most cases." *Id.* at 9-10 (citation omitted). Thus, one result of limiting *Central Bank* to "non-scheme" cases would be to increase D&O insurance premiums (and lead to more insurance coverage litigation), with little or no benefit to defrauded investors (as distinguished from their attorneys). To the extent that such policies cover the new exposure, the resulting premiums may eventually place them beyond the reach of many smaller or mid-size businesses and those in higher-risk industries, leading to more rather than less harm to investors.

Moreover, reversal of the decision below would put all property and casualty insurers at risk. Insurers could be especially vulnerable to being added as "deep pocket" defendants in securities fraud lawsuits. Reversal could subject insurers to class action liabilities arising from even routine business activities.

In the normal course of their business, insurers often collect confidential business information, including information on financial risks, from potential insureds in the underwriting process and from current clients in the claims process. The standard proposed by Petitioner multiplies the opportunities for securities class action litigators to devise creative arguments alleging scheme liability.

The claims in a lawsuit or a series of related lawsuits against a publicly traded company can exceed the company's insurance coverage. Where an insurer is aware of a substantial risk faced by a public company that is not fully covered by insurance, is the insurer required to make certain that its insured reports the exposure properly in its financial statements, at the risk of possibly becoming a defendant in a securities fraud lawsuit if the insured does not do so?

For example, when a product liability claim is asserted against an insured manufacturer, the insurer commonly investigates the design of the product involved. That investigation may reveal that the product was in fact poorly designed, or was marketed with inadequate warnings (or even using false representations). Regardless of what the insurer does, the manufacturer may face liabilities for products already on the market that exceed the insurance policy's limits. After the insurer responds to damage claims up to the policy's limits, would the insurer be exposed to a claim that it participated in a scheme to defraud if the manufacturer does not disclose a material uninsured exposure in the manufacturer's financial statements?

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Similarly, must a surety bond issuer take steps to determine whether a publicly traded contractor covered by the bond discloses its financial difficulties when the insurer is required to step in and complete a project which the contractor is financially unable to complete, to avoid the risk that the surety will be forced to defend against a claim that by not speaking it participated in a scheme to defraud the contractor's shareholders? What if a fidelity bond issuer reimburses its insured for the dishonest acts of a highly placed employee in a public corporation: must the fidelity bond insurer take steps to make certain that the dishonesty is disclosed in the insured's financial statements, or risk being sued as a participant in a scheme to hide the truth from the insured's investors?

The point is that, by virtue of the nature of the insurance relationship, insurers often acquire significant knowledge of an insured's business and its attendant risks. If the Court were to hold that the mere allegation of a scheme to defraud is sufficient to take the case out of *Central Bank*, insurers may be particularly vulnerable to claims that they participated in an actionable scheme to defraud by not publicly disclosing those risks. And because insurers are required to maintain state-mandated levels of assets to cover their obligations to policyholders and to continue writing insurance, insurers are especially attractive targets of plaintiffs' attorneys, who know that they need not be concerned with whether the potential defendant has insurance.

The resulting cost of such expanded liability would be borne by insurers' business customers in every industry, without in any way enhancing the availability of commercial coverages. Enforcement action by the SEC remains available in appropriate cases. 15 U.S.C. § 78t(e), as does

criminal liability in egregious situations. 15 U.S.C. § 78ff; 18 U.S.C. § 2. Insurers also are subject to strict financial regulation and market conduct oversight by regulators in all 50 states and the District of Columbia. Insurers and insurance markets should not run the additional risk of incurring the substantial costs of defending against private actions under section 10(b) whenever creative counsel for a plaintiff is able to allege that there was a scheme to defraud and that someone other than the primary violator facilitated the scheme.

Finally, the insurance industry does business with a large number of service suppliers. The extension of liability sought by Petitioner would (1) increase the chances that an insurer might unwittingly enter into a contract that is later claimed to be part of a scheme to defraud perpetrated by the insurer's contractor, or (2) make potential service suppliers wary of doing business with publicly traded insurers, thereby reducing the pool of willing suppliers or increasing the insurer's cost of doing business with them.

In short, Petitioner's argument would essentially create new risks for anyone who deals with a publicly traded entity. Those who deal with publicly traded companies should not be made, in effect, insurers of the accuracy of such companies' financial statements.

Were the Court inclined to limit *Central Bank*, it should do so very carefully, lest a Pandora's Box of vastly increased securities litigation inadvertently result. The Court in *Central Bank* indicated that eliminating section 10(b) aiding and abetting liability "does not mean that secondary actors . . . are always free from liability under the securities Acts." *Central Bank*, 511 U.S. at 191. The

Court specifically referred to several categories of actors – "a lawyer, accountant, or bank," *id.* – as likely candidates. Each of those categories has an especially unique relationship with a securities issuer and occupies a place of trust that sets them apart from routine vendors whose relationship is episodic rather than being one of a close and trusted adviser. They may owe duties that transcend the normal business relationship. That is not the case for routine vendors such as insurers.

CONCLUSION

WHEREFORE, for the foregoing reasons, *Amici Curiae* American Insurance Association and the Property Casualty Insurers Association of America respectfully urge the Court to affirm the Order of the court of appeals.

Respectfully submitted,

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STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR AMICI CURIAE STATES OF ARKANSAS, NEW JERSEY, RHODE ISLAND, AND THE NEW YORK STATE COMMON RETIREMENT FUND, PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM, PENNSYLVANIA STATE EMPLOYEES' RETIREMENT SYSTEM, AND THE MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM OF MICHIGAN IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS CURIAE[1]

The Amici States, as guardians of the citizenry, have a paramount interest in the enforcement and proper interpretation of the securities laws. The States give recognition to and confer both rights and responsibilities on corporations. Thus, the reach of the federal securities laws, and the scope of conduct covered by those laws, are of great concern to the States and their citizens.

The Amici public pension funds, as fiduciaries to the public employees who rely on them to prudently manage their retirement funds, are among the largest institutional investors, public or private, in the United States, and have a special responsibility to help insure the transparency of the capital markets and the accountability of their participants.

Together, the Amici States and the Amici public pension funds manage an aggregate $360 billion invested in the public markets. Combined, they manage the retirement plans for over over 2.7 million active and retired public servants. Increasingly, the Amici States and Amici public pension funds act as lead plaintiffs in securities class actions, and in the aggregate currently serve as lead plaintiffs in 14 pending securities class actions. As lead plaintiffs, Amici play a pivotal role in enforcing and deterring violations of the securities laws and in recovering losses for investors and pensioners victimized by fraud. As large public institutional investors, Amici are especially effective lead plaintiffs, just as Congress contemplated when it devised the lead plaintiff provisions of the Private Securities Litigation

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[1] Pursuant to this Court's Rule 37.6, Amici state that no counsel for any party authored this brief in whole or in part, and no person or entity other than amicus curiae, its members, or its counsel, has made a monetary contribution to the preparation or submission of brief. Pursuant to Rule 37.3, the parties' letters of consent to the filing of this brief have been lodged with the Clerk.

Reform Act of 1995, and as courts have consistently recognized since.

The Court's decision in this case will greatly impact the Amici States' ability to fulfill their roles as protectors of the public interest, and the Amici public pension funds' ability to fulfill their roles as fiduciaries of publicly managed funds.

SUMMARY OF ARGUMENT

The Securities Exchange Act of 1934 forbids "any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe. . . ." 15 U.S.C. §78j(b).[2] By its terms, the statute places no limits on the persons who can be liable or on the types of "manipulative or deceptive devices or contrivances" that are prohibited. Thus,

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[2] The Securities and Exchange Commission ("SEC") has promulgated Rule 10b-5, 17 C.F.R. § 240.10b-5, which prohibits

> any person, directly or indirectly . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The decision below did not address the scope of the rule, which has been held to be "coextensive with the coverage of § 10(b)," *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002), but instead analyzed only whether the alleged conduct could be considered manipulative or deceptive under the statute, *see In re Charter Communications, Inc., Securities Litigation*, 443 F.3d 987, 992-93 (8th Cir. 2006).

under any reading, this language must forbid persons or entities from structuring transactions in a manner that has no legitimate business purpose other than to permit the creation of false financial statements for public distribution.

Disregarding the statute's text, the Eighth Circuit in *In re Charter Communications, Inc., Securities Litigation*, 443 F.3d 987 (8th Cir. 2006), concluded that nothing in Section 10(b) forbids third-party entities from intentionally engaging in sham transactions for the purpose of having those transactions falsely reported to the investing public by their business partners. The court reached this surprising conclusion in three steps, each of which was error.

First, the court erred by adopting a constricted reading of the statute to forbid only the making of false statements (or misleading omissions) and manipulative trading practices. However, as this Court has previously made clear, the statute forbids all forms of deceptive conduct that are intended to falsely affect the price of a security. When the fraud is ultimately consummated through the issuance of a false financial statement, as occurred in this case, the statute prohibits any acts that caused the statement to issue, so long as those actions are "deceptive." Because sham contracts, wash transactions, and the like are "deceptive" under any definition of that term, and because – as alleged here – such transactions were necessary to the fraud's consummation, liability should lie under Section 10(b).

The Eighth Circuit's next error was to conclude that liability will lie for an omission only if the actor operates under a preexisting fiduciary duty of disclosure. Because, in the Eighth Circuit's view, outside entities that do business with fraudsters operate under no such duty, the court concluded that the vendor-defendants could not be held liable for failing to disclose the false financial reporting. The Eighth Circuit thus failed to

recognize that both this Court and others have repeatedly emphasized that one who intentionally participates in another's breach of fiduciary duty inherits the same duties of disclosure as the original fiduciary – and is equally liable for a failure to disclose material information. Because the vendors in this case intentionally participated in just such a breach by purposefully providing Charter's corporate officers with information intended to be falsely reported to the investing public, the vendors were subject to a duty of disclosure. They can thus be held liable for remaining silent in the face of Charter's fraud.

Finally, the Eighth Circuit reasoned that, despite the vendor-defendants' purposeful injection of false information into the market, the vendors had not made, nor caused to be made, any false statements. However, every circuit to consider the issue has agreed that Section 10(b) not only forbids persons from personally making false statements, but also forbids persons from channeling false information to the market through intermediaries and third parties. In this case, the vendors intentionally provided false information to Charter for the purpose of having Charter distribute that information to the public in its financial statements. The vendors may thus be held liable for the damages caused by that false information.

ARGUMENT

I. MODERN COMPLEX FRAUDS RELY ON THE PARTICIPATION OF MULTIPLE ACTORS

It is no coincidence that certiorari petitions in *Charter Communications*, *Regents of University of California v. Credit Suisse First Boston (USA), Inc.* ("*Credit Suisse*"), 482 F.3d 372 (5th Cir. 2007), and *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), came before this Court at roughly the same time. These actions, with facts that, as the Fifth Circuit observed, are "extraordinarily similar," *Credit Suisse*, 482 F.3d

at 388, are emblematic of the sophisticated forms of accounting fraud that have been at the center of a wave of scandals dating from the late 1990s. These scandals, which have resulted in the spectacular implosions of some of Wall Street's biggest names, have had one thing in common: the degree to which the fraud could never have been accomplished but for the active, intentional, and purposeful participation of third parties – auditors, bankers, insurers, and business partners.

The extent to which these frauds have depended on the participation of outside entities has by now been well documented. Not only did these outside entities engage in transactions designed for the sole purpose of hiding their clients' debt and (falsely) increasing clients' reported revenues and cash flow, but, in many cases, auditors, insurers, and investment bankers specifically designed new fraudulent structures and openly marketed them to their clients. For instance, Robert Roach, Chief Investigator for the Senate Permanent Subcommittee on Investigations, testified before Congress that a number of financial institutions intentionally sold fraudulent, Enron-style accounting structures known as "prepays" to their other clients:

> [JP Morgan] Chase developed a "pitch book" to sell other companies on Enron-style prepays. The presentation describes the transactions as "Balance sheet 'friendly'." It also sets out in general terms Chase's use of its special purpose entity, Mahonia, in structuring the trades and clearly explains that the trades are orchestrated to work together. This explanation of the deliberate packaging of the trades flatly contradicts claims that the trades are independent and unrelated. Chase apparently entered into Enron-style prepays with seven companies apart from Enron.

> Citigroup also developed a presentation to sell companies on Enron-style prepays, promoting, in particular, the Yosemite structure it had developed ... Citigroup shopped this Enron-style prepay to 14 companies, successfully selling it to at least three."

1 *The Role of Financial Institutions in Enron's Collapse: Hearings before the Permanent Subcomm. Of Investigations of the Senate Governmental Affairs Committee*, 107th Cong. (2002) (statement of Robert L. Roach, Chief Investigator, Permanent Subcomm. on Investigations). The accounting firm of Arthur Andersen developed a "white paper" that it distributed to telecommunications companies, explaining how to avoid certain accounting standards in order to create fictitious revenue. *See* Dennis K. Berman, Julia Angwin and Chip Cummins, *Tricks of the Trade: As Market Bubble Neared End, Bogus Swaps Provided a Lift*, Wall St. J., Dec. 23, 2002, at A1. And in 2003, the insurance company A.I.G. paid $10 million to settle the SEC's charge that it had "played an indispensable part" in the fraud at a company called Brightpoint by selling it an insurance product "that A.I.G. had developed and marketed for the specific purpose of helping issuers to report false financial information to the public." Gretchen Morgenson, *S.E.C. Wants a Monitor to Examine A.I.G.'s Books*, N.Y. Times, Nov. 3, 2004, at C1.

Under any ordinary reading of the Securities Exchange Act of 1934 ("Exchange Act"), this would seem to be precisely the kind of conduct forbidden by the statute. Section 10(b), 15 U.S.C. § 78j(b), makes it unlawful for any person "directly or indirectly . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." The Exchange Act was passed in the aftermath of the 1929 market crash, and, in addition to outlawing a number of specific manipulative

practices, included Section 10(b) as a "catch-all" provision to prohibit "any other cunning devices" that were not identified elsewhere in the statute or that might be developed after the statute's passage. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-03 (1976) (quoting legislative history). The statute was explicitly intended to address the fact that some fraudulent conduct takes place "behind the scenes": not only does it ban use of manipulative devices both "directly" and "indirectly," but, as this Court acknowledged, the statute applies equally to issuers and to lawyers, banks, and accountants, for "[i]n any complex securities fraud, [] there are likely to be multiple violators." *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 191 (1994).

But despite what would appear to be the plain language of the statute and the obvious intention of Congress to ban precisely this sort of behavior – which, as alleged in this action, involves planned, premeditated, and coordinated market manipulation – the Eighth Circuit in *Charter*, followed by the Fifth Circuit in *Credit Suisse*, determined that when an outside entity intentionally engages in transactions for the purpose, and with the effect, of having those transactions falsely reported to the market through the financial statements of clients and customers, such conduct is neither "manipulative" nor "deceptive." *See Charter*, 443 F.3d at 992-93; *Credit Suisse*, 482 F.3d at 387-90. Rather, both courts concluded that such conduct can be no more than "aiding and abetting" – conduct that, per this Court's decision in *Central Bank*, is not prohibited by the text of Section 10(b). *Central Bank*, 511 U.S. at 177-78.

If permitted to stand, these decisions provide a road map for committing fraud, and represent a true threat to the integrity of the securities markets. As Professor Coffee has observed, third party "gatekeepers" play a critical role in keeping corporations honest. *See* John C. Coffee, *Understanding Enron:*

"It's About the Gatekeepers, Stupid," 57 Bus. Law. 1403 (2002). These gatekeepers may be more responsive to the threat of liability than their clients, for they depend on reputational capital to maintain their businesses, *see, e.g.*, Paul Beckett and Jathon Sapsford, *Citigroup's Vast Reach Brings It Trouble From Many Quarters*, Wall St. J., July 26, 2002, at A1, and they do not reap the immediate "benefits" of fraud through increases in their own stock prices. Insulating gatekeepers from liability for the costs of their misconduct will encourage future frauds. Nor can it be said that governmental enforcement actions will provide all required deterrence; as Congress has explained, "[P]rivate lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31, at 31 (1995); *see also* Brief for the United States as Amicus Curiae Supporting Petitioners at 1, *Tellabs Inc. v. Makor Issues & Rights*, No. 06-484 (Feb. 9, 2007) ("[M]eritorious private actions are an essential supplement to criminal prosecutions and civil enforcements.").

II. SECTION 10(B) FORBIDS PARTICIPATION IN TRANSACTIONS INTENTIONALLY DESIGNED TO ENABLE FRAUD

A. *Central Bank* and its History

Prior to this Court's decision in *Central Bank*, it was generally accepted among the circuits that liability would lie for aiding and abetting violations of Section 10(b). Because the penalties for aiding and abetting were often similar to those for primary violations, courts rarely distinguished between the two types of liability. *See In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 494 (S.D.N.Y. 2005); *see also Shapiro v. Cantor*, 123 F.3d 717, 720 n.2 (2d Cir. 1997). Frequently, courts characterized

any conduct by a secondary *actor*, such as an outside auditor, as "aiding and abetting," even when the actor directly issued false statements under its own name – conduct that today would be easily recognized as sufficient to incur primary liability. *See Parmalat*, 376 F. Supp. 2d at 495 (discussing cases).

Courts also differed as to how "aiding and abetting" was defined. For instance, in *Harmsen v. Smith*, 693 F.2d 932 (9th Cir. 1982), the Ninth Circuit listed the elements of aiding and abetting as "(1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong." *Id.* at 943. In *DBLKM, Inc. v. Resolution Trust Corp.*, 969 F.2d 905 (10th Cir. 1992), the Tenth Circuit held that recklessness would satisfy the scienter element of an aiding and abetting claim. *See id.* at 909. And in *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986), the Seventh Circuit required that the alleged aider and abetter have "committed one of the 'manipulative or deceptive' acts or otherwise met the standards of direct liability." *Id.* at 495. That court distinguished its aiding and abetting test from primary liability by requiring that the primary violator "offer or sell the securities." *Id.*[3] In many circuits, the scienter requirement for aiding and abetting liability varied with the degree of assistance the alleged aider had provided the primary violator; the more substantial the assistance, the lower the scienter requirement. *See Metge v. Baehler*, 762 F.2d 621, 624-25 (8th Cir. 1985). Thus, at the time *Central Bank* was decided, the boundary between "primary" and "secondary" liability was, at best, fluid.

In *Central Bank*, this Court for the first time held that Section 10(b) does not impose liability on those "who do not

[3] This Court has since made clear that no such requirement exists for primary liability to attach. *See Central Bank*, 511 U.S. at 191.

engage in the manipulative or deceptive practice, but who aid and abet the violation." 511 U.S. at 166-67. Reasoning that "the statutory text controls the definition of conduct covered by § 10(b)," *id.* at 175, this Court held that aiding and abetting was not covered by the statute because the statutory text limited its prohibitions to "manipulative or deceptive acts in connection with the purchase or sale of securities.," *id.* at 173.

Critically, however, for the purpose of its analysis, the Court employed the following definition of aiding and abetting: "(1) a primary violation of § 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor." *Id.* at 168; *see also id.* at 190 (emphasizing that "recklessness, not intentional wrongdoing, is the theory underlying the aiding and abetting allegations in the case before us"). The Court did not address the various permutations of aiding and abetting liability that had been applied in the lower courts and, because the plaintiff in *Central Bank* had not charged the defendant with primary liability, the Court was not called upon to distinguish reckless substantial assistance to a primary violator from prohibited conduct "involving manipulation or deception." The *Central Bank* Court thus did not undertake an analysis of what sorts of "acts" might qualify as "manipulative or deceptive" under the statute. As a practical matter, the Court held only that liability under Section 10(b) requires manipulative or deceptive conduct, and that the formulation of reckless substantial assistance was overly broad, "extend[ing] beyond persons who engage, even indirectly, in a proscribed activity . . . but who give a degree of aid to those who do." 511 U.S. at 176.

Notwithstanding *Central Bank*'s clear directive that "the statutory text controls the definition of conduct covered by § 10(b)," 511 U.S. at 175, the Eighth Circuit nonetheless

determined that conduct unquestionably deceptive under any ordinary meaning of the word – the creation of sham contracts and wash transactions with no economic substance – is not forbidden by the statute. *Charter*, 443 F.3d at 992-93. In so doing, the court eschewed any analysis of the statutory text itself; instead, it interpreted this Court's prior cases to have given Section 10(b) a narrow application only to defendants "who [] make or affirmatively cause to be made a fraudulent misstatement or omission, or who [] directly engage in manipulative securities trading practices." *Id.* at 992. Indeed, in *Credit Suisse*, the Fifth Circuit elaborated on the *Charter* court's reasoning by arguing that the word "deceptive" was not to be interpreted in accord with its dictionary definition, but in accord with (what it perceived to be) this Court's "limit" on the "scope" of the term. 482 F.3d at 389. The Eighth and Fifth Circuits' interpretations of *Central Bank* and this Court's other cases are unduly constrained and ignore the plain statutory text.

B. The Eighth Circuit's Overly Narrow Interpretation of Section 10(b) Should be Rejected

The Eighth Circuit's decision rested on three basic propositions. First, as described above, it construed Section 10(b) to forbid only two forms of conduct: false statements (or misleading omissions) and manipulative stock trades. *Charter*, 443 F.3d at 992. Second, the court determined that because the vendor-defendants in this case had not directly made any false statements, and had not engaged in manipulative trading, they could only be held liable for misleading omissions. *Id.* Third, the court concluded that because the vendors had no fiduciary relationship with Charter's shareholders and had not personally issued false statements, they were under no duty to disclose the fraud. *Id.* Each of these conclusions was in error.

i. Section 10(b) Forbids All Forms of Manipulative and Deceptive Conduct

This Court has interpreted the language of Section 10(b) to prohibit "any course of conduct that has the effect of defrauding investors," *Ernst & Ernst*, 425 U.S. at 212, and has made clear that a deceptive course of conduct, within the meaning of Section 10(b), includes participation in a "scheme" to defraud. In *Ernst & Ernst*, for example, this Court defined "device" as "an invention; project; scheme; often, a scheme to deceive." 425 U.S. at 199 n.20. Similarly, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), this Court approvingly quoted the Second Circuit that "§ 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Id.* at 10 n.7 (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)).

Despite the statutory text and this Court's clear admonition that *all* forms of manipulation and deception are forbidden by the statute – including participation in "schemes" – the Eighth Circuit nonetheless reached the conclusion that Section 10(b) forbids only two things: false statements (and misleading omissions), and "manipulative securities trading practices." 443 F.3d at 992. Further, though the statute by its terms applies to anyone who employs a manipulative or deceptive device "directly or indirectly," the Eighth Circuit eschewed this language and instead held that only defendants who "make or affirmatively cause to be made" false statements, or who "directly engage" in manipulative trading, are covered by Section 10(b). *Id.* Such narrow statutory construction is not only flatly at odds with this Court's prior holdings, but confuses the *source* of the injury experienced by the plaintiffs with the *conduct* that led to the injury.

The plaintiffs in this action claim that they were defrauded by Charter's false reports of revenues and cash flows. Complaint ¶12 (JA20a). Thus, the plaintiffs have alleged that they were injured by a false statement, just as the Eighth Circuit required. The only remaining question, then, is whether liability exists for the deceptive conduct that underlies and causes the false statement to issue. And by the plain terms of the statute, it does.

First, there can hardly be any dispute that plaintiffs have alleged that the contracts, wash transactions, and the like were "employed" by the vendors. The vendors are alleged to have signed the contracts, accepted overpayments, and funneled revenues back to Charter. Complaint ¶¶90-114 (JA52a-61a). The vendors actively engaged in the transactions, and thus "employed" them for statutory purposes. *See* Webster's New International Dictionary 839 (2d ed. 1934) (defining "employ" as "to make use of, as an instrument, means, or material; to apply; use; . . . .").

Second, as the Ninth Circuit explained in *Simpson*, it is difficult to imagine how participation in a transaction, "the principal purpose and effect of which is to create the false appearance of fact," 452 F.3d at 1048, can be anything other than "deceptive" under any understanding of that term. The vendors here were alleged to have entered into sham contracts and wash transactions, and they were alleged to have done so for the purpose of having those transactions be communicated to the public through Charter's financial statements. This is the very definition of deceptive. *See, e.g.*, Webster's New International Dictionary 679 (2d ed. 1934) ("tending to deceive; having power to mislead").

The Eighth Circuit faltered at this point by limiting the concept of a "deception" only to the issuance of a false statement (or misleading omission), which, it concluded, the vendors had

not done. *Charter*, 443 F.3d at 992; *see also Credit Suisse*, 482 F.3d at 389 (conceding that the accounting structures at issue qualified as "devices," under this Court's precedent, but disputing that they were "deceptive"). But nothing in the statute requires that a deceptive device be a false statement or omission. Even if the Eighth Circuit is correct that ultimately the fraud can only be *consummated* through a false statement or misleading omission to the market, the statute forbids "devices" and "contrivances," not statements, and therefore must be taken to forbid not only the statements themselves, but also those devices and contrivances that *cause* false statements to issue.[4] This is why this Court has already explained that deceptive "devices" include participation in a scheme. *See Ernst & Ernst*, 425 U.S. at 199 n.20. Such liability would be redundant if only applied to those who had affirmatively made false statements; rather, if the "devices" forbidden by the statute include "schemes," then they must necessarily include some forms of conduct that, perhaps on their own are not direct false statements to the market but, taken in conjunction with other actions,

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[4] Of course, had the truth behind Charter's financial statements been disclosed, there would have been no injury, but that fact alone does not transform the case into one based on misleading omissions. Because the securities laws are fundamentally directed at disclosure, *see, e.g.*, *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985); *Santa Fe*, 430 U.S. at 477 ("fundamental purpose of 1934 Act to substitute a philosophy of full disclosure for the philosophy of caveat emptor. . . ." (quotations omitted)), at bottom, every injury premised on affirmative conduct can be reduced to a failure to disclose. *See, e.g.*, *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) ("if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."); *Zandford*, 535 U.S. at 821 (unauthorized trading is deceptive because it was undisclosed); *Santa Fe*, 430 U.S. at 477 (nondisclosure is "essential to the success" of a manipulative trading scheme).

ultimately result in false communications. *See, e.g.*, Webster's New International Dictionary 2234 (2d ed. 1934) (defining scheme as a "plan or program of something to be done; an enterprise; a project . . . A crafty, unethical project"). And, because this Court has already acknowledged that "[i]n any complex securities fraud, [] there are likely to be multiple violators," *Central Bank*, 511 U.S. at 191, there is no reason why the different parts that together constitute a "scheme" – including a scheme to issue false financial statements – must all be undertaken by a single actor.

To support its constricted reading of the statute, the Eighth Circuit quoted *Central Bank*'s statement that "As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Charter*, 443 F.3d at 990 (quoting *Central Bank*, 511 U.S. at 177). However, had the Eighth Circuit quoted the entire passage, it would have been clear that the *Central Bank* Court was concerned with *deception*, not particular forms of conduct:

> As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. *See Santa Fe Industries* [*v. Green*,] 430 U.S. [462,] 473 [(1977)] ("language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); *Ernst & Ernst*, 425 U.S. at 214 ("When a statute speaks so specifically in terms of manipulation and deception . . . , we are quite unwilling to extend the scope of the statute"). The proscription does not

> include giving aid to a person who commits a manipulative or deceptive act.

511 U.S. at 177. This paragraph is not an affirmative holding that the only forms of conduct that violate §10(b) are "statements" (and omissions), and "manipulations." Read in context, it is clear that the Court was addressing the broader point whether liability would lie for any actions that were not, in some sense, deceptive. This is why the Court cited *Santa Fe* and *Ernst & Ernst*, both of which concerned only the question whether unintentional or nondeceptive actions would violate the statute, *see Santa Fe*, 430 U.S. at 473-74; *Ernst & Ernst*, 425 U.S. at 197-99, and why the Court, both in this paragraph and elsewhere in its opinion, repeatedly referred less specifically to deceptive "acts," "conduct," and "practices."

Not surprisingly, then, in *Credit Suisse*, the Fifth Circuit did *not* rely on this passage to support its conclusion that the statute prohibits only statements, omissions, and manipulative trading. Instead, the Fifth Circuit construed the *Central Bank* decision as "informed by a series of decisions . . . narrowly defining the scope of 'fraud' in the context of securities." *Credit Suisse*, 482 F.3d at 387. According to the Fifth Circuit, the *Central Bank* Court, by relying on decisions such as *Santa Fe* and *Ernst & Ernst* (which discussed the concept of "manipulation"), and *Chiarella v. United States*, 445 U.S. 222 (1980) (which noted that claims based on "omissions" must include allegations of a "duty to speak"), had affirmatively limited the scope of potential "manipulative" and "deceptive" acts to the conduct specifically discussed in those opinions. *See Credit Suisse*, 482 F.3d at 387-90. But a cursory glance at the *Central Bank* decision shows that this is simply not so: *Central Bank* relied on these cases *not* in the context of discussing the types of *acts* that would violate the statute, but to make the broader point that Section 10(b) liability turns on

misrepresentation, nondisclosure, or deception – which, the Court believed, was not involved in aiding and abetting liability. So, for example, the Court characterized the *Ernst & Ernst* decision as turning on the need to "protect investors from false and misleading practices," 511 U.S. at 173-74, and described *Santa Fe* as holding that Section 10(b) does not "reach[] breaches of fiduciary duty . . . without any charge of misrepresentation or lack of disclosure," *id.* at 174. Nothing in *Central Bank* even addresses whether conduct other than an affirmative statement, omission, or manipulative trade might be considered "deceptive," and as explained above, the *Central Bank* Court would have had no reason to decide the issue, because the plaintiffs in that action "concede[d] that Central Bank did not commit a manipulative or deceptive act." *Id.* at 191.

The plaintiffs' allegations here also satisfy the element of reliance. As explained above, the plaintiffs' injuries are ultimately traceable to the false statements that Charter issued, and in which the vendors participated. The only question is whether the vendors' deceptive conduct led to the issuance of the false statements. *See Credit Suisse*, 482 F.3d at 397 (Dennis, J., concurring). In this case, not only was the conduct essential to the fraud, but it is also possible to identify exactly the false information that the vendors injected into the market through Charter, and its attendant effect on the value of Charter securities. Therefore, the plaintiffs have properly alleged that they "relied" on the false statements. *See generally Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (element of reliance satisfied by a showing that false information affected market price of the security).

Central Bank is not to the contrary. There, this Court expressed concern that were the aiding and abetting action proposed "in this case" to go forward, plaintiffs would be able to proceed against the alleged aider and abettor, Central Bank,

without a showing of reliance. 511 U.S. at 180. But in that case, Central Bank was alleged merely to have delayed an independent assessment of property values underlying a bond issue, after having already received an appraisal concluding the lands were sufficient collateral. *Id.* at 167-68. The court of appeals had undertaken only a cursory analysis of the relationship of the bank's actions to the primary actor's fraudulent bond issue, *First Interstate Bank, N.A. v. Pring*, 969 F.2d 891, 904 (10th Cir. 1992), with no discussion of what an independent appraisal might have yielded, when it would have been complete, or what effect it might have had on the issue. In other words, in that case, the relationship between Central Bank's actions and the ultimate injury was far more speculative than the relationship alleged here. *See Basic*, 485 U.S. at 243 (explaining that the element of reliance "provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury").

Finally, holding outside entities liable under the facts of this case does not threaten to revive aiding and abetting liability. As explained above, the *Central Bank* Court rejected aiding and abetting liability because it would have improperly extended the proscription of §10(b) to those who merely aided persons who committed manipulative or deceptive acts. The liability proposed on the facts of this case would extend only to defendants who engaged in transactions for the purpose of creating a "false appearance of fact." *Simpson*, 452 F.2d at 1048. "The focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only defendants who use or employ a manipulative or deceptive device) are held liable under the Act." *Id.* at 1049.

ii. Participation in Fraudulent Conduct Triggers a Duty to Disclose

The Eighth Circuit equally erred in concluding that those who intentionally participate in sham transactions for the purpose of enabling fraud have no duty to disclose that fact. To the contrary, in the same way that a corporation, once it has chosen to speak, must speak fully and truthfully, and correct statements that were false when originally issued, *see, e.g.*, *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2002); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 561 (6th Cir. 2001) (en banc); *Overton v. Todman & Co., CPAs, P.C.*, 478 F.3d 479, 486 (2d Cir. 2007), *Oran v. Stafford*, 226 F.3d 275, 285-86 (3d Cir. 2000); *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990) (en banc), so too does intentional, active participation in fraud give rise to a duty of disclosure.

In *Chiarella*, for example, this Court explained that a "tippee" who wrongly receives confidential information from a corporate fiduciary inherits the same fiduciary duties to disclose the information or refrain from trading on it. *See* 445 U.S. at 230 n.12. As this Court explained, "the tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." *Id.*; *see also Dirks v. SEC*, 463 U.S. 646, 659 (1983) ("[T]he tippee's duty to disclose or abstain is derivative from that of the insider's duty.").[5]

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[5] In *Dirks*, a pre-*Central Bank* case, the tippee-defendant had been charged by the SEC with aiding and abetting the original breach. This Court did not discuss the nature of the SEC charge, but merely discussed the source of a tippee's own duty to the corporation's shareholders. Notably, in *Chiarella*, which involved primary liability, this Court also discussed the tippee's own duty to shareholders, approvingly citing *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), in which tippees were charged with primary violations

(Cont'd)

The tippee's status as a participant, moreover, turns on his knowledge; though he assumes no fiduciary obligations if he is unaware of the wrongfulness of the insider's conduct, the tippee "assumes a fiduciary duty to the shareholders of a corporation [when] . . . the tippee knows or should know that there has been a breach." *Dirks*, 463 U.S. at 647.

The *Chiarella* and *Dirks* decisions are by no means unusual; numerous courts both before and after *Central Bank* have recognized that the existence of a duty of disclosure depends on an examination of several factors, including the defendant's degree of participation in the fraud and its level of scienter. For instance, in *Rudolph v. Arthur Andersen*, 800 F.2d 1040 (11th Cir. 1986), the Eleventh Circuit explained that a court may consider, among other things, "the extent of the defendant's knowledge and the significance of the misstatement . . . . The extent of the defendant's participation in the fraud might also be important." *Id.* at 1043; *see Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1206 (11th Cir. 2001) (same). Similarly, the Ninth Circuit has explained that a duty to disclose arises from the "knowing assistance of or participation in a fraudulent scheme." *Harmsen*, 693 F.2d at 944 (quotation omitted).[6] Indeed, the

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(Cont'd)
of Section 10(b). Today, the SEC regularly charges tippees with primary violations of Section 10(b). *See, e.g.*, *SEC v. Warde*, 151 F.3d 42, 47 (2d Cir. 1998); *SEC v. Franco*, 253 F. Supp. 2d 720, 727 (S.D.N.Y. 2003).

[6] Though the Ninth Circuit discussed this disclosure duty in the context of aiding and abetting liability, as described above, that court also defined such liability more strictly than did this Court in *Central Bank*. *See Harmsen*, 693 F.2d at 943. Moreover, courts' failure to carefully distinguish aiding and abetting from primary liability prior to *Central Bank* makes the labels unenlightening; though the Ninth Circuit described this disclosure duty as "secondary," the Eleventh Circuit relied in part on Ninth Circuit precedent when it determined that violation of a disclosure duty arising from participation in fraud constitutes *primary* liability under Section 10(b). *See Rudolph*, 800 F.2d at 1043.

Restatement (Second) of Torts, relied upon in *Chiarella*, 445 U.S. at 228 n.9, emphasizes that there may be a duty to disclose "facts basic to the transaction, if [the defendant] knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, *the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts*." *Id.* § 551(2)(a) (emphasis added). The comments note that courts have required disclosure in situations where "the advantage taken of the plaintiff's ignorance is so shocking to the ethical sense of the community, and is so extreme and unfair, as to amount to a form of swindling," *id.* cmt. k.

Under the standards elucidated above, the Eighth Circuit was simply wrong to hold that third parties have no duties to disclose frauds committed by the people with whom they do business. When those third parties not only have actual knowledge of fraud, but also intentionally participate in it – through sham transactions, or artificial structures designed with the purpose and effect of enabling improper accounting treatment, or "any other cunning devices," *Ernst & Ernst*, 425 U.S. at 202 – those third parties inherit the same duties of disclosure as the original corporation, and may be liable for breaching that duty by remaining silent. Certainly, a person would "reasonably expect disclosure" if a third party, such as a vendor or a lender, knew that its transactions were being falsely described to the public. *Cf. Rudolph*, 800 F.2d at 1044 ("Standing idly by while knowing one's good name is being used to perpetrate a fraud is inherently misleading.").

Nor would imposing a disclosure duty under circumstances such as these revive the aiding and abetting standards rejected in *Central Bank*. *Central Bank* concerned only "reckless," not "purposeful," behavior. *Central Bank*, 511 U.S. at 190. This is a relevant distinction, for it is the third party's level of knowledge

about the wrongdoing of the original fiduciary that gives rise to the reasonable expectation of disclosure and the derivative fiduciary duties. *See Dirks*, 463 U.S. at 661 ("[Tippee] responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty . . ." (quotation omitted)); *Rudolph*, 800 F.2d at 1043 ("A defendant who intentionally did not reveal what he knew to be fraud might more reasonably be expected to speak out than a defendant who merely failed to learn of a material but ambiguous omission."). Moreover, *Central Bank* did not examine the liability of one who furthers the fraud by engaging in transactions intentionally structured for the purpose of being falsely reported to the public – but this is precisely the conduct that distinguishes one who gives "a degree of aid" to persons engaging in fraudulent conduct, 511 U.S. at 176, from the type of active participation that triggers the derivative fiduciary duty of disclosure.

iii. Section 10(b) Forbids Entities from Using Others as Conduits to Distribute False Information to the Public

Finally, the Eighth Circuit erred in concluding that the vendors cannot be held responsible under Section 10(b) for Charter's false statements. To the contrary, when an entity deliberately supplies false information to another party with the purpose and intent that it be communicated to the public, that entity has violated Section 10(b). Because the vendors here are alleged to have purposefully supplied Charter with false information in the form of sham contracts and fictional rate increases, they, too, are liable for false public communications that incorporated such information.

It is widely agreed among the circuits that a person cannot escape liability under Section 10(b) by using another person as

a "conduit" to communicate false information to the market. Thus, in *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997), a corporation was accused of having provided false information to analysts, who then used that information to issue unduly positive recommendations to the public. *See id.* at 623-24. Notwithstanding the fact that the false information had been channeled to the market through third parties, the Ninth Circuit explained that "corporate defendants may be directly liable under 10b-5 for providing false or misleading information to third-party securities analysts." *Id.* at 624. As that court explained, a defendant "cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties." *Id.* (quoting *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996)). *Cooper*'s holding that entities may not use other persons as "conduits" to channel false information to the market has won wide acceptance among the courts of appeals. *See Rombach v. Chang*, 355 F.3d 164, 174 (2d Cir. 2004) (quoting *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163-64 (2d Cir. 1980)); *Southland Secs. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 373 (5th Cir. 2004); *In re Navarre Corp. Secs. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002). Indeed, even the *Charter* court apparently recognized the validity of the theory, for it carefully allowed that liability would attach if a defendant "affirmatively cause[d] to be made a fraudulent misstatement or omission." *Charter*, 443 F.3d at 992.[7]

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[7] The 1934 Congress was unquestionably aware of, and concerned about, the use of ostensibly independent parties to funnel false information to the market. As the Senate Committee report explained:

> Other devices commonly resorted to in the past, and banned by the bill are the dissemination of false information and tipster sheets. The record shows that it was not uncommon for market operators to employ a publicity agent to tout a stock in which they were momentarily interested. In one

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If there were any remaining doubt, it would be resolved by looking to common law at the time of the Act's passage.[8] At that time, the *Restatement (First) of Torts* explained:

> The maker of a fraudulent misrepresentation in a business transaction is subject to liability to another who acts in justifiable reliance upon it if the misrepresentation, although not made directly to the other, is made to a third person for the purpose of having him repeat its terms or communicate its substance to the other in order to influence his conduct in a particular transaction or type of transaction.

Restatement (First) of Torts § 533. For the purposes of this

(Cont'd)

> instance a financial writer on a great New York newspaper was discovered to have been a regular participant in the profits of a free-lance trader, without obligation except to publicize the stocks of the trader. Another witness admitted that his business was 'financial publicity', and that his articles were published for the purpose of interesting the public in the stock in which he and those who employed him were interested, thereby causing the market value of the stock to increase; and for this work he was paid by calls and options. Still other cases were observed where persons were employed to broadcast over the radio, ostensibly as economists tendering gratuitous advice, but in reality as publicity agents of stock-exchange firms.

S. Rep. No. 792, 73d Cong., 2d Sess., at 8 (1934).

[8] The Exchange Act was passed in part to broaden the common law protections against fraud, *see Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983); therefore, common law understandings of fraud are helpful in understanding the type of conduct Congress sought to prohibit.

principle, it is irrelevant that the vendors may not have had their own independent pecuniary interest in defrauding Charter's shareholders. As the *Restatement* explained, "[t]he misrepresentation must be made for the purpose of having it repeated in terms or communicated in substance to the third person. If it is made for such purpose, the rule is applicable although the maker of the representation has no interest, either direct or indirect, in the transaction in which its repetition influences the third person." *Id.* cmt. b.[9]

To be sure, the Second Circuit, relying on *Central Bank*, held in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), that to trigger Section 10(b) liability, false information distributed through another entity must be publicly attributed to its original source. *See id.* at 175. The circuit reasoned that there can be no "reliance" if the public is unaware of the origin of the statement. *See id.* But the *Wright* court – apparently unwilling to overrule the conduit theory (which carries no such caveat) – drew a distinction between "primary" actors who channel false statements to the market through intermediaries, and "secondary" actors who do the same thing, holding only that "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination." *Id.* at 175.[10]

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[9] The *Restatement (Second) of Torts* espouses the same principle. *See Restatement (Second)* § 533.

[10] In *Wright*, the "secondary actor" was alleged to have done no more than simply review and approve the false statements. *Wright*, 152 F.3d at 175. The Second Circuit observed that even if secondary actors could be responsible for unattributed statements, the defendant's participation in that instance was likely too slight to incur liability. *See id.* at 175-76. In this case, of course, the vendors are alleged to have done far more than simply "review" Charter's statements; they are alleged to have contributed substantive, and false, content.

As should be immediately obvious, there is simply no basis in the statute or even logic to draw such a distinction. If an investor must know the identity of the original source of the information in order to "rely" on it, there is no reason why that rule should be any different when the anonymous participant is a "secondary" rather than a "primary" actor. More importantly, people rely on *information*, not speakers – and though the perceived source of the information may contribute to its materiality (a statement by a corporate issuer might carry more weight than, say, a statement by a lone internet commenter) – the relevant question is whether *information* supplied by the (anonymous) actor was relied upon by the public. Indeed, this Court itself has previously held that secondary actors *can* be held liable under Section 10(b) when they assist in the preparation of statements that are not attributed to them – it is, in fact, the potential for such liability that distinguishes liability under Section 10(b) from liability under Section 11 of the Securities Act of 1933, and was one of the reasons that this Court held that Section 11 was not the sole remedy for false statements in registration statements:

> [C]ertain individuals who play a part in preparing the registration statement generally cannot be reached by a Section 11 action. These include corporate officers other than those specified in 15 U.S.C. § 77k(a), lawyers not acting as "experts," and accountants with respect to parts of a registration statement which they are not named as having prepared or certified. If, as Herman & MacLean argues purchasers in registered offerings were required to rely solely on Section 11, they would have no recourse against such individuals even if the excluded parties engaged in fraudulent conduct while participating in the registration statement. The

> exempted individuals would be immune from federal liability for fraudulent conduct even though Section 10(b) extends to "any person" who engages in fraud in connection with a purchase or sale of securities.

Herman & MacLean v. Huddleston, 459 U.S. 375, 386 n.22 (1983).

Therefore, it is hardly surprising that most courts have not embraced *Wright*'s "attribution" theory or its distinction between "primary" and "secondary" actors – *Wright* is mainly cited for a variety of other propositions. *See, e.g.*, *Weiss v. S.E.C.*, 468 F.3d 849, 855 (D.C. Cir. 2006) (citing *Wright* for the proposition that a defendant "could incur liability for his misrepresentations even when he did not communicate them directly to investors"); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004) (citing *Wright* to support its finding of no liability where auditor-defendant "did not assist in the preparation or presentation of this financial information, nor did it ever express an opinion about it.").

Here, it is alleged that the vendors intentionally provided false information to Charter – through sham price increases, sham advertising revenues, false contracts, and so forth – for the express purpose of having Charter then communicate that information to the public via its financial statements. Though ordinarily entering into a business transaction might not be considered to be a "statement" or the furnishment of information in the ordinary sense, as alleged here, the transactions were not designed for ordinary business purposes but instead existed to be communicated publicly. In other words, the transactions in question were "employed" by the vendors as a device to mislead the market. Thus, the Eighth Circuit was simply incorrect to conclude that "[n]one of the alleged financial misrepresentations by Charter was made by or even with the approval of the

Vendors," *Charter*, 443 F.3d at 992; to the contrary, the vendors supplied false information, and most certainly approved of Charter's misrepresentations, by intentionally engaging in sham business transactions for their informational value.

Nor is it relevant that, in this instance, Charter officers knew that the information supplied by the vendors was false when they incorporated it into Charter's public statements. In *Cooper*, many of the analyst-conduits were alleged to have known that the corporation was feeding them false information, and yet the corporation was still deemed liable for false information that was channeled to the market. *See Cooper*, 137 F.3d at 625. Moreover, joint participants in a fraud have long been treated as equally liable, without any requirement that one be acting as an innocent agent of another. *See Dirks*, 463 U.S. at 659 (the transactions of those who knowingly participate with the fiduciary in such a breach are "as forbidden" as transactions "on behalf of the trustee himself" (quoting *Mosser v. Darrow*, 341 U.S. 267, 272 (1951)); *Chiarella*, 445 U.S. at 230 n.12 ("The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."); *Huddleston*, 459 U.S. at 659 n.22 (Section 10(b) liability will lie for all parties who "engaged in fraudulent conduct while participating in the registration statement"); *Mertens v. Hewitt Associates*, 508 U.S. 248, 254 (1993) (at common law, knowing participants in a trustee's breach of duty were liable to the beneficiary).

Indeed, it seems that the only potential relevance of Charter's own belief, or not, in the false information supplied by the vendors would be if Charter's informed decision to include the false information in its financial statements constituted a supervening cause that broke the chain of causation between the vendors' conduct and the plaintiffs' injuries. However, it is by now well established that the intervening

conduct of another entity – even wrongful, or criminal conduct – is not a supervening cause unless it is entirely unforeseeable and unrelated to the original misconduct. *See, e.g.*, *Atchison, Topeka & Santa Fe Ry. Co. v. Calhoun*, 213 U.S. 1, 7 (1909); *Whitehead v. Food Max of Mississippi, Inc.*, 163 F.3d 265, 271 (5th Cir. 1998); *Marshall v. Perez Arzuaga*, 828 F.2d 845, 848 (1st Cir. 1987). Here, the vendors' participation – far from being divorced from plaintiffs' injuries – was actually necessary to Charter's fraud; had they not agreed to engage in wash transactions and other devices, Charter would not have been able to falsify its financial statements in the manner alleged.

CONCLUSION

As succinctly stated by Circuit Judge Dennis concurring in *Credit Suisse*, the interpretations of the Fifth and Eighth Circuits "immunize[] a broad array of undeniably fraudulent conduct from civil liability under Section 10(b), effectively giving secondary actors license to scheme with impunity, as long as they keep quiet." 482 F.3d at 394 (Dennis, J., concurring). This is not what the plain language of the statute requires, and cannot be what was intended by the 1934 Congress. For that reason, the Eighth Circuit's decision should be reversed.

Respectfully submitted,

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No. 06-43

IN THE

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STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR ATTORNEYS' LIABILITY ASSURANCE SOCIETY, INC. AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether the Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims brought under a "scheme" liability theory pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §.78j(b), and SEC Rule 10b-5(a) & (c), 17 C.F.R. § 240.10b-5(a) & (c).

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SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR ATTORNEYS' LIABILITY ASSURANCE SOCIETY, INC. AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

INTEREST OF THE *AMICUS CURIAE*

Attorneys' Liability Assurance Society, Inc. ("ALAS") is the country's leading provider of professional liability insurance for large law firms.[1] Its membership includes 245 major law firms and 58,000 attorneys in 46 states and the District of Columbia—approximately one of every thirteen attorneys in private practice. ALAS member firms have

[1] Pursuant to Rule 37.6, no counsel for a party to this case authored any part of this brief, and no person or entity, other than the *amicus*, made a monetary contribution to the preparation or submission of this brief. All parties have consented to the filing of this *amicus curiae* brief, and their consent letters are on file with the Clerk of the Court.

advised virtually every significant public company in the United States. Among other services, ALAS provides its insured attorneys with extensive loss prevention advice, and it is widely credited as both the originator and leader of that discipline. Lawyers from ALAS's Loss Prevention staff were actively involved in the American Law Institute's development of the Restatement Third, The Law Governing Lawyers, and in the ABA Ethics 2000 Commission's revision of the Model Rules of Professional Conduct, completed in 2002, and they are involved in many other professional and bar association bodies that have defined the ethical and professional duties of lawyers. As part of its insuring duties, ALAS monitors the defense of professional liability claims asserted against its insured attorneys and law firms. By virtue of the many services it renders, ALAS has a unique understanding of the problems confronting law firms today. To this end, ALAS has filed numerous *amicus* briefs addressing issues of vital concern to the nation's legal community.

The question of "scheme" liability and its contours is of substantial importance to ALAS and the attorneys it insures and, derivatively, to the universe of public companies that look to ALAS lawyers for advice. If *Central Bank*'s clear rule were now eclipsed in fraud-on-the-market cases like this one by a multi-factor test that required consideration of the nature and degree of the involvement of lawyers and other secondary actors, then clever and unscrupulous plaintiffs would be able to craft their complaints to satisfy these tests. Trial courts must accept the well-pled facts as true, with the result that many complaints alleging financial statement fraud by public companies would survive threshold motions by secondary actors and launch them into hugely expensive fact discovery. Whether a lawyer actually gave the advice or performed the acts alleged in the complaint, or even knew of the client's fraud, cannot be raised until summary judgment at the earliest. These lawsuits invariably filed to force huge settlements, can be catastrophic for a law firm. Rather than

take the risk of being drawn into such catastrophic liability and damaging publicity, well-counseled law firms would avoid giving securities advice to troubled public companies – those clients that most need their help.

The social cost of this scenario would be unacceptably high, especially where the Securities & Exchange Commission ("SEC") has ample tools to deal with private law firms that shirk their professional duties. Put another way, a decision that gave the plaintiffs' securities bar a means of suing private law firms through artful pleading of a "scheme" to inflate a public corporation's financial statements would be unwise. It would be susceptible to abuse. It would disturb the equilibrium that now allows lawyers to advise troubled companies in need of legal counsel. And it would deter some lawyers from providing important professional services. ALAS has a strong interest in seeing that plaintiffs cannot, through artful pleading, reintroduce the uncertainty put to rest by *Central Bank*, thereby opening law firms and their insurers to billions of dollars in potential damages and settlement costs.

STATEMENT

Petitioner, Charter Communications, Inc. ("Charter"), a cable television provider, entered into contracts with two equipment vendors, Respondents Scientific-Atlanta, Inc. and Motorola, Inc., to provide set-top boxes that enable cable subscribers to receive programming. The contract provided that the boxes would be supplied for a fixed price. The complaint alleged, however, that Charter entered into transactions to artificially inflate its financial earnings by paying each respondent an additional $20.00 per set-top box, in return for their returning the additional payments to Charter in the form of advertising fees. The vendors, according to plaintiffs, knew that Charter was undertaking these transactions to inflate its financial picture.

While plaintiffs did not allege that the vendors had prepared or made any of the false or misleading financial statements issued to the investing public, they did assert that the vendors had participated in a scheme to defraud investors by artificially boosting the company's reported financial results and, accordingly, that the vendors were liable in damages under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (b) and implementing Rule 10b-5(a) & (c), 17 C.F.R. § 240.10b-5.

The district court, relying on this Court's decision in *Central Bank*, dismissed the complaint. Pet. App. 30a-71a. The court of appeals affirmed. *Id.* at 1a-11a. The Eighth Circuit relied primarily on the Court's ruling in *Central Bank* that Section 10(b) prohibits only "manipulative or deceptive" devices or contrivances and that the scope of Rule 10b-5 can be no greater than that of the underlying legislation. In rejecting Petitioner's attempt to invoke subsections (a) and (c) of Rule 10b, the court further observed that the scheme argument "depends on the assertion that *Central Bank's* analysis did not affect the scope of primary liability under subparts (a) and (c)," which the court found to be an unjustifiably narrow reading of *Central Bank*. Instead, the court found three governing principles in *Central Bank* and earlier decisions of the Court: that a private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b), including claims under Rule 10b-5(a) and (c); that a device or contrivance is not deceptive within the meaning of the statute absent a misstatement or failure to disclose by one who has a duty to disclose; and that the term manipulative in § 10(b) is a "term of art and refers to illegal trading practices such as wash sales, matched orders or rigged prices that are intended to mislead investors by artificially affecting market activity." Pet. App. 8a (internal quotations omitted). The court further concluded that a device or contrivance is not deceptive, within the meaning of § 10(b), "absent some misstatement or a failure to disclose by one

who has a duty to disclose;" and that to constitute manipulation with the meaning of Section 10(b), a secondary actor must "directly engage in manipulative trading practices." *Id.* at 8a-9a.

The court of appeals observed that "the focus of plaintiffs' § 10(b) and Rule 10b-5 claims was deception" by Charter in that plaintiffs had "alleged a 'continuous course of conduct' in which Charter allegedly 'made and/or failed to correct public representations that were or had become materially false and misleading regarding Charter's financial results and operations.'" *Id.* at 9a. Finding that the plaintiffs' allegations against the vendors under subparts (a) and (c) of Rule 10b-5 were an attempt to reinstitute aiding and abetting liability for Charter's false and misleading public statements under Section 10(b), and therefore were barred by *Central Bank*, the court affirmed the dismissal of the complaint. The court concluded that "any defendant who does not make or cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5." *Id.* at 9a. The court further ruled that adopting plaintiffs' position on scheme liability "would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress." *Id.* at 10a.

SUMMARY OF THE ARGUMENT

The policy issue that concerned the Court in *Central Bank* was that in the absence of clearly defined standards for liability under the anti-fraud statutes, professionals other than the securities issuer would be subject to abusive litigation. The Court emphasized that "the rules for determining aiding and abetting liability are unclear, in '*an area that demands certainty and predictability.*'" 511 U.S. at 188 (emphasis

added) (citation omitted). The Court, therefore, gave § 10(b) a clear and predictable reach. This certainty has allowed lawyers and law firms to provide securities disclosure advice to their clients with the assurance that doing so will not expose them to massive civil liability based on an artfully-drafted class action complaint wrongfully accusing the lawyers of participating in their client's fraud.

If the clear rule of *Central Bank* were replaced with an unpredictable multi-factor test that turns on allegations concerning the nature and degree of the involvement of lawyers and other secondary actors in a public company's alleged scheme to defraud investors, then the certainty provided by *Central Bank* would be lost. Lawyers and other professionals would be drawn into abusive litigation, for the more general the legal test, the easier it is to prepare a complaint that appears to meet the test and can survive a motion to dismiss. Trial judges who deny motions to dismiss are seldom willing to certify their rulings for interlocutory review under 28 U.S.C. § 1292(b), thereby propelling lawyers into crushingly expensive discovery. As the Court has recognized, plaintiffs with largely groundless claims should not be permitted to "take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value," *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955, 1966 (2007) (quotations omitted). This is, however, precisely what occurs in securities litigation. Vindication at the end of a long case is in theory possible, but in reality "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those [trial] proceedings." *Id.* at 1967. The costs of defense and the potential for massive exposure in jury trials has led to an environment in which virtually all private securities cases that survive motions to dismiss are settled. And the settlements are dauntingly large.

The naming of securities lawyers as defendants could well become commonplace if scheme liability, with its vague and varying standards, were adopted by the Court. Securities lawyers regularly deal with complex issues and are often called upon to advise clients based on factual information that is incomplete or in flux. The assessment of a particular situation may also require the application of unsettled principles of law. Since disclosures are generally complex, it will often be possible, with hindsight, to allege that important information was omitted and that securities counsel was one of the background actors responsible. The role of the transactional lawyer providing services to large public companies such as the ones involved in securities class actions would be similarly subject to aggressive pleading under a scheme liability theory, since some action of counsel could always be labeled, with hindsight, as deceptive for purposes of withstanding a motion to dismiss. At the pleading stage, the law firm has no ability to explain these complex and fact-bound questions to the court.

The adoption of a scheme liability theory of secondary actor liability would likely also produce conflicts of interest generated by the tension between the attorney's duties to the client and preservation of the attorney-client privilege, on the one hand, and a scheme theory that, at least in some formulations, holds the attorney to the standard of "gatekeeper" and financial watchdog, on the other. Thus, scheme liability could as a practical matter punish the attorney for professionally responsible behavior.

At the same time, adoption of a scheme theory of secondary actor liability could chill well-counseled law firms from representing troubled public companies in securities-related work. An illustration of this phenomenon is the litigation aftermath of the savings and loan crisis of the 1980's when federal regulatory agencies embarked on a

campaign of lawsuits against directors of, and counsel for, many failed thrifts and banks. Recognizing that these suits were driven by a quest for their liability insurance, many commercial insurance carriers (although not *amicus*) introduced "regulatory" and other exclusions in their policies that foreclosed insurance coverage for claims arising out of failed banks and thrifts. The inclusion of a regulatory exception then caused many of the larger and well-advised law firms to avoid altogether representing troubled financial institutions and those that were in weakened financial positions—the group that one could argue most needed seasoned legal advice. Scheme liability, used as a tool to force settlements from attorneys and their insurers, could have a similar chilling effect on the willingness of attorneys to represent troubled public companies.

Therefore, if the court of appeals ruling were reversed, and the principles and reasoning of *Central Bank* abandoned, there would be widespread uncertainty concerning the reach of the securities laws with substantial detrimental consequences for securities attorneys and the companies they advise. In light of the SEC's unquestioned authority to pursue claims against outside counsel for aiding and abetting client misconduct, and its Sarbanes-Oxley authority to discipline attorneys appearing and practicing before it, there is no need to extend the implied right of action of § 10(b) to scheme liability, as Petitioner requests.

ARGUMENT

I. THE SCHEME LIABILITY THEORY WOULD REINSTATE THE VERY UNCERTAINTY THAT *CENTRAL BANK* SOUGHT TO ELIMINATE AND WOULD EXPOSE ATTORNEYS TO RUINOUS CIVIL LIABILITY AT CONSIDERABLE AND UNWARRANTED SOCIAL COST.

This Court is familiar with the nature of class action securities lawsuits, their potential for abuse and the detrimental and sometimes catastrophic effects such lawsuits have had on defendants. Lawyers and law firms have not been sued as often as other professionals in securities class actions involving exchange-traded securities since *Central Bank*. Yet there is no question that the scheme liability theory advanced by Petitioner would, if adopted as a basis for secondary actor liability in fraud-on-the-market cases like this one, permit clever plaintiffs to sweep attorneys into the morass of these lawsuits. Often enough, the attorneys will have been doing no more than carrying out their traditional roles as client advisors. Nonetheless, attorneys would be sued, damaged in the public eye, and would become targets for high priced settlements.

A. The securities class action is widely seen as uniquely susceptible to abuse. As the Court recently observed, securities litigation presents "a special risk of vexatious litigation" and is a "particularly troublesome subset of class actions." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 86 (2006) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). One commentator recently referred to the securities class action lawsuit as "the 800-pound gorilla that dominates and overshadows other forms of class actions." John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1539 (2006). In

these actions, "the settlement payments and the litigation expenses of both sides fall largely on the defendant. . . ." *Id.* at 1536. Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. 104-67, 109 Stat. 737 (Dec. 22, 1995), to remedy "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent.'" *Dabit*, 547 U.S. at 81 (*citing* H. R. Rep. No. 104-369 at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730).[2] Despite PSLRA safeguards such as a heightened pleading standard, securities class action complaints often survive threshold motions since at the motion to dismiss stage trial courts must accept the factual allegations as true. Denials of threshold motions launch the parties into hugely expensive fact discovery.

Trial judges who deny motions to dismiss are seldom willing to permit interlocutory review under 28 U.S.C. § 1292(b). Thus, while plaintiffs with groundless or marginal claims should not be permitted to "take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value," *Bell Atlantic Corporation v. Twombly*, 127 S. Ct. 1955, 1966 (2007) (quotations omitted), this is exactly what occurs in securities litigation. The fear of litigating class actions is

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[2] Congress, when enacting the PSLRA, observed that the act was prompted by "the routine filing of lawsuits against issuers of securities . . . whenever there is a significant change in the issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action." H.R. Rep. 104-369 at 31. The legislative history noted that "[a] complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence," S. Rep. No. 104-98, at 8 (1995), while "[t]he dynamics of private securities litigation create powerful incentives to settle, causing securities class actions to have a much higher settlement rate than other types of class actions," *id.* at 6.

magnified by the specter of joint and several liability, a liability out of proportion to the alleged wrong.

This common scenario presents defendants with the choice of settling at great expense or litigating for years—and then possibly facing a jury with billions of dollars at stake. And, almost invariably, "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those [trial] proceedings," *Twombly* at 1967, for defendants typically cannot "stake their companies on the outcome of a single jury trial." *In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995). These so-called "blackmail settlements" induced "by a small probability of an immense judgment" have long been recognized as a significant problem with the class action device. *See* Henry J. Friendly, *Federal Jurisdiction: A General View* 120 (1973); Fed. R. Civ. P. 23(f), 1998 advisory committee notes (1998 amends.) ("An order granting certification . . . may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability."). In sum, it is common knowledge that "[p]rivate securities fraud actions . . . can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007).

Not surprisingly, therefore, in private securities fraud class litigation, "virtually all cases are settled." Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 578 (1991). Indeed, according to one report, "no case has been tried since the PSLRA went into effect; all have either been settled or dismissed." *See* Richard Painter et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis* 7 (Federalist

Soc'y for Law & Pub. Policy Studies 2002).[3] Even a claim that is later dismissed may inflict serious reputational damage, cost huge amounts to defend, and produce a sizeable settlement. *See* Jonathan Weil, *Win Lawsuit—and Pay $300 Million*, Wall St. J., Aug. 2, 2004, at C3. Since the merits of the law underlying these securities class action lawsuits are seldom, if ever, tested by an appeal to a federal court of appeals, plaintiffs have a huge incentive to bring these lawsuits, without much regard to the merits of their claims.[4]

The settlements, moreover, are often dauntingly large, and for the last several years they have been rising. As Cornerstone Research's recently issued 2006 Review and Analysis reports, "[l]ike 2005, 2006 proved to be another record-breaking year for securities case settlements." Laura E. Simmons, Ellen M. Ryan, Cornerstone Research, *Securities Class Action Settlements: 2006 Review and Analysis*, at 1 (2007). Even excluding the $6.6 billion partial settlement in Enron, "the total value of cases settled during the year exceeded all previous years, reaching an unprecedented $10.6 billion. In addition, while median settlement amounts changed little, average settlement amounts in 2006 increased

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[3] *See* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2064 (1995); Woodruff-Sawyer & Co., *A Study of Shareholder Class Action Litigation* 25 (2002). As the Second Circuit remarked in *Goldberger v. Integrated Resources Inc.*, 209 F.3d 43, 52 (2d Cir. 2000), "[Melvyn I.] Weiss and his partner William S. Lerach of the Milberg firm have stated that losses in these cases are 'few and far between,' and that they achieve a 'significant settlement although not always a big legal fee, in 90% of the cases [they] file.'" (*quoting In re Quantum Health Res. Inc. Sec. Litig.*, 962 F. Supp. 1254, 1258 (C.D. Cal. 1997)).

[4] While the absolute number of private securities fraud suits appears to have peaked for now as a result of a sustained rise in the stock market, they will undoubtedly explode again with any significant market correction or fall.

almost five-fold to reach their highest levels to date." *Id.* The recently issued Bloomberg-Schumer Report, authored by McKinsey & Co. and the New York City Economic Development Corporation, confirms that "[t]he total bill for securities settlements in 2005 was $3.5 billion (omitting WorldCom-related settlements of approximately $6.2 billion), up more than 15 percent over 2004, and nearly 70 percent over 2003."[5]

B. It is self-evident that scheme liability, with its indefinite standards, would fuel securities litigation. The more broadly a legal test is framed, the easier it is for an artful pleader to draft a complaint likely to withstand a motion to dismiss. In fact, the policy issue that deeply concerned the Court in *Central Bank*, and shaped its ruling, was that in the absence of clearly defined standards for liability under the antifraud statutes, attorneys and other securities professionals would be subject to abusive litigation. The Court stated that "the rules for determining aiding and abetting liability are unclear, in '*an area that demands certainty and predictability.*'" 511 U.S. at 188 (emphasis added) (citation omitted). Obviously, in a situation where "settlements in large [securities] class actions can be divorced from the parties' underlying legal positions," *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004), having "bright-line" rules to guide conduct and define legal rights and liabilities is essential.

Notwithstanding the need for certainty and predictability, the scheme liability decisions that have been crafted by the lower courts to date base liability on imprecise rules with predictably inconsistent results. *See Simpson v. AOL Time Warner*, 452 F.3d 1040, 1048 (9th Cir. 2006) (defendant "must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance

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[5] *See Sustaining New York's and the US's Global Financial Services Leadership*, (Jan. 2007) at 73-74.

of the scheme;" allegations that third party vendors entered into sham round-trip and barter transactions as part of scheme to inflate public company's reported revenues held insufficient to state § 10(b) claim against vendors); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 502-04 (S.D.N.Y. 2005) (defendant must have "directly or indirectly used or employed any device or contrivance with the capacity or tendency to deceive;" banks held subject to scheme liability for securitizing and factoring allegedly worthless receivables to inflate public company's reported cash flow but not for allegedly making high-interest loans disguised as equity investments or assets in order to allow company to misreport its debt level); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336 (S.D.N.Y. 2004) (accountants subject to "scheme" liability for their "central role" as "chief architect" of misleading accounting and transactions used to inflate client's revenues); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) (defendant must have "substantially participated in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device . . . intended to mislead investors;" defendants held subject to scheme liability for allegedly setting up and operating shell software companies to provide licensing revenue to inflate public company's bottom line). As the district court in *In re Lernout & Hauspie Sec. Litig.* admitted, "the line between primary and secondary liability in a scheme or course of business case can be murky and fact-sensitive." *Id.*

In *Simpson v. AOL Time Warner*, the Ninth Circuit rejected the position of the SEC, similar to that urged by Petitioner here, that a defendant qualifies as a primary violator when he or she engages "in a transaction whose principal purpose and effect is to create a false appearance of revenues." 452 F.3d at 1048. Recently, SEC Commissioner Atkins observed in testimony before the House Financial Services Committee that "based on experience," the position put forward by his agency with respect to scheme liability was wrong. Speaking

of a proposed *amicus curiae* brief in this case, which the Solicitor General of the United States did not authorize,[6] Commissioner Atkins stated that "I dissented from our brief because based on experience, you know . . . I didn't think our test worked. And that's through experience at the SEC and then also seeing what the various circuits came up with." *See A Review of Investor Protection and Market Oversight With the Five Commissioners of the Securities and Exchange Commission*, Hearings Before the House Financial Services Committee, 110th Cong., 1st Sess. (June 26, 2007) (official pagination not yet available).[7] Commissioner Casey agreed with this assessment, stating that "the brief before us was overly vague and broad in terms of the sweep of conduct that would be included, potentially including conduct that would normally be charged as aiding and abetting liability." *Id.* SEC Chairman Cox, in testimony during the same hearing,

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[6] The SEC voted 3-2 to file a brief as *amicus curiae*, in support of Petitioner in this case. The Solicitor General declined to authorize the brief, allegedly after communication with the White House. While the Solicitor General is almost always the final decision-maker with respect to these matters, Presidents (including Truman, Eisenhower, and Clinton) and Attorneys-General have on occasion intervened in these decisions. *See* Drew S. Days III, *When the President Says "NO": A Few Thoughts On Executive Power and The Tradition of Solicitor General Independence*, 3 J. Appellate Prac. and Process 509, 519 (2001) (concluding that the President "is ultimately responsible, in both legal and political terms, for the positions his administration takes in court."). In any event, the views of the SEC would not be entitled to deference in a case where a judge-made implied right of action is at issue, the question turns on the reach of the statute, and the Court previously rejected the SEC's arguments in *Central Bank*, the very case being revisited. *See Dirks v. SEC*, 463 U.S. 646, 656 (1983) (rejecting the SEC's position because it "differs little from the view we rejected as inconsistent with congressional intent" in an earlier case).

[7] The hearing proceedings have not yet been published. They are available, however, from Lexis/Nexis, Federal News Service, Inc.

stated that scheme liability must be understood as only applying to "a primary actor, a principal violator." *Id.*

The standards of liability announced by the lower court rulings, and suggested by the SEC as an *amicus curiae* in litigation, have one thing in common: because of their imprecision they would increase the already intense pressure on defendants to settle class action lawsuits without regard to the lawsuit's merits because these tests for scheme liability provide no clear and predictive rules, notwithstanding that this is "an area that demands certainty and predictability." *Central Bank*, 511 U.S. at 188.

C. Not only would scheme liability fuel securities litigation, but plaintiffs' success at the motion to dismiss stage would be significantly enhanced because the scheme liability theory virtually reads out of the legal equation the reasonable reliance element that this Court in *Central Bank* found to be so important. The Court in *Central Bank* explained that permitting aiding and abetting liability under § 10(b) would allow plaintiffs to "circumvent the reliance requirement," since a defendant "could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." 511 U.S. at 180. Reasonable reliance serves to establish the causal connection between a defendant's misrepresentation (or other "action") and a plaintiff's injury that is required for plaintiff to recover damages.

Despite the paramount importance of demonstrating reasonable reliance in a case brought pursuant to § 10(b), the facts of this case illustrate how dangerously open-ended Petitioner's theory is and how the reliance requirement, an important safeguard, would be all but eliminated by the liability theory urged by Petitioner. Even though the "focus" of Petitioner's § 10(b) claim was that investors had been deceived by Charter's false and misleading public statements, the district court, in dismissing the complaint, observed that plaintiffs "do not assert that Scientific-Atlanta and Motorola

made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them;" that plaintiffs "do not allege that Scientific-Atlanta or Motorola were responsible for, or were involved with, the preparation of Charter's allegedly false or misleading financial statements," its "improper internal accounting practices," or the "false or misleading financial statements" made by Charter and its former executives; that "[p]laintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by Scientific-Atlanta and Motorola," and that plaintiffs "have not alleged that Scientific-Atlanta or Motorola had any duty to Charter's investors." Pet. App. 41a. Respondents explained in their appellate briefs that they had accounted for the transactions properly and lawfully in their own financial statements, had expected Charter to do the same, and did nothing to hide the transactions. (Br. of Scientific-Atlanta, Inc. at 3).

If the Court were to find scheme liability appropriate on these facts, then anyone who did business with, or supplied information to, a public company, whether or not an investor relied upon or even knew about the transaction or the information, could be drawn into securities litigation.[8] In these circumstances, the attorney, and his or her insurer, would be easy targets.

Securities lawyers regularly deal with complex issues and are often called upon to assess and advise clients based on factual information that is incomplete or in flux—facts that are not subject to an unequivocal analysis. The assessment of a particular situation, moreover, may call for the application

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[8] Petitioner leaves reliance for the very end of its brief and makes no cogent arguments in support of this key element of a 10(b) cause of action. Indeed, Petitioner admits that "Respondents did not themselves disseminate the false information to the securities market." Pet. Br. at 38.

of unsettled principles of law. Since disclosures are often complex, it will always be possible, with hindsight, to allege that important information was omitted and that securities counsel was one of the background actors responsible. *See* Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons*? 48 Vill. L. Rev. 1097, 1128 (2003) ("[t]he quality of the attorney's counsel is a function of the quality of information he receives from the client."). The role of the transactional lawyer providing services to large public companies such as the ones involved in securities class actions would be similarly subject to aggressive pleading under a scheme liability theory, since some action of counsel could always with hindsight be labeled as deceptive for purposes of withstanding a motion to dismiss.

The impact that such amorphous standards can have on a law firm is well-illustrated by the securities litigation arising out of the collapse of Enron. The district court in January 2002 ruled that, accepting the facts pled as true, the plaintiff class had stated a claim under Rule 10b-5 against several secondary actors, including the law firm of Vinson & Elkins LLP ("V&E"). The court adopted a "creator" theory of liability of secondary actors for false statements made by issuers. Under this theory, which had been proposed by the SEC, a person can be a primary violator if he or she authors misrepresentations (or perhaps allows material facts to be omitted) in a document to be given investors, even if the idea for those misrepresentations came from someone else. *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 704 (S.D. Tex. 2002). The court accepted as true the allegations lodged against V&E that it was "not merely a drafter but essentially a co-author" of Enron's public disclosures, and it denied the firm's motion to dismiss. As a bankruptcy examiner later observed in an exhaustive report, and V&E demonstrated in its motion for summary judgment, V&E's role in the disclosures was actually limited and episodic, and the law firm had no control over Enron's

ultimate disclosures. *In re Enron Corp., et al.*, No. 01-16034 (AJG), United States Bankruptcy Court, Southern District of New York, *Final Report of Neal Batson, Court Appointed Examiner, Appendix C, Role of Enron's Attorneys*, at 84, 87. Yet it was not until 2007, after suffering years of extraordinarily expensive and disruptive discovery, and with no ruling on its motion for summary judgment, that the law firm was eventually dismissed voluntarily as a party. Financial and reputational harm to the law firm had already occurred.

D. Prior to *Central Bank*, most decisions involving allegations against law firms concerned aiding and abetting liability. While as a general matter the courts' decisions in the aiding and abetting cases tended to construe a lawyer's duties narrowly,[9] the cases failed to offer consistent guidance.[10] The very same amorphous terms now used to characterize scheme liability, including "participation" and "substantial assistance," were applied by the courts.

This Court in *Central Bank* determined that the various tests then utilized by courts to determine secondary liability lacked clarity and produced decisions "made on an ad hoc basis, offering little predictive value." 511 U.S. at 188-89

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[9] *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyer's Responsibility for Clients' Fraud*, 46 Vand. L. Rev. 75, 84-94 (1993) (observing that prior to *Central Bank*, the case law narrowly construed a lawyer's duties in aiding and abetting cases).

[10] *Compare Schatz v. Rosenberg*, 943 F.2d 485, 497 (4th Cir. 1991) (lawyers had no fiduciary duties to disclose client's misrepresentation where they "did no more than 'paper the deal' or act as a scrivener"), *cert. denied*, 503 U.S. 936 (1992) and *Abell v. Potomac Insurance Co.*, 858 F.2d 1104, 1124 (5th Cir. 1988) ("In general, the law recognizes such suits only if the non-client plaintiff can prove that the attorney prepared specific legal documents that represent explicitly the legal opinion of the attorney preparing them, for the benefit of the plaintiff."), *vacated on other grounds, Fryar v. Abell*, 492 U.S. 914 (1989), *with SEC v. Forma*, 117 F.R.D. 516, 526 (S.D.N.Y. 1987) (attorney's "silence consciously intended to facilitate a fraud can create secondary liability").

(quotation omitted). Moreover, "because of the uncertainty of the governing rules, entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Id.* at 189. The Court went on to give § 10(b) a clear and predictable reach and, on the basis of the statute, found no provision for aiding and abetting liability. This certainty has permitted lawyers and law firms to provide securities disclosure advice and do transactional legal work for their clients with the assurance that doing so will not expose them to massive civil liability based on an artfully-drafted class action complaint wrongfully accusing the lawyers of participating in their clients' fraud.

Scheme liability for secondary actors in securities fraud cases would return the state of the law to its pre-*Central Bank* days, making attorneys and other secondary actors vulnerable to a securities lawsuit where the primary purpose of the litigation is not vindication on the merits, but achieving a windfall settlement.

II. IMPOSITION OF SCHEME LIABILITY COULD AS A PRACTICAL MATTER PUNISH THE ATTORNEY FOR PROFESSIONALLY RESPONSIBLE BEHAVIOR AND CREATE POTENTIAL CONFLICTS OF INTEREST.

Recent corporate disasters, such as Enron and WorldCom, have turned attention to lawyers and other third party professionals, who are often referred to as "gatekeepers." Ignoring the differing roles and responsibilities of the different professions, some commentators have posited that these gatekeepers should all be viewed as having duties to the investing public. However, as this Court has noted, in contrast to the accountant, who "[b]y certifying the public reports that collectively depict a corporation's financial status

. . . assumes a *public* responsibility transcending any employment relationship with the client," the lawyer's role is that of "the client's confidential adviser and advocate." *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

Lawyers generally have no duty to disclose information to non-clients. A lawyer advising a client, including a public company, owes his or her duties of loyalty solely to that client. Model Rules of Prof'l Conduct R. 1.13(a). That duty is to render advice consistent with the interests of the client. Further, under Rule 1.2(a), ABA Model Rules of Professional Conduct, the lawyer is obligated to respect the client's decision-making authority—authority which in a public company rests with management and the board of directors. The lawyer, therefore, generally owes no primary duties under Rule 10b-5 to investors. *Schatz v. Rosenberg*, 943 F.2d 485, 491 (4th Cir. 1991), *cert. denied*, 503 U.S. 936 (1992) ("[A]bsent a fiduciary or other confidential relationship, lawyers have no duty to disclose information about clients to third party investors."). Accordingly, unless the attorney speaks with the intention that a third party investor will rely on his or her statements, representation of clients is shielded by a lawyer's duty to zealously represent his client.

The attorney, in addition, is bound by the attorney-client privilege, the oldest privilege recognized at common law. As the Court observed in *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1991), the purpose of the privilege

> is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client.

The Court noted that this policy concern is very strong when a corporation is the client, "[i]n light of the vast and complicated array of regulatory legislation confronting the modern corporation." *Id.* at 392. And the Court held that the rules governing the attorney-client privilege should be broadly construed to encourage corporations to comply with the applicable law. *Id.*

The attorney-client privilege, in order to promote a full and frank exchange of information between the client and the attorney and thereby permit the most effective legal representation, generally bars disclosure of protected information to the public. This does not mean, of course, that the attorney can ignore the interests of the investing public when advising clients. The attorney must be aware of the client's duties to the public and the consequences to the client of a violation of such duties. Absent direct affirmative misconduct, for example when an attorney lies to an investor intending that the investor rely on the lie or files with the SEC client statements that the attorney knows to be false, attorneys should be deemed as having duties to their public corporate clients only with an obligation to preserve client confidences. Attorneys, accordingly, differ from other so-called gatekeepers like accountants, who do have traditional and recognized duties directly to the public.

If attorneys could be targeted under scheme liability theories for their clients' fraudulent securities disclosures, conflicts of interest would inevitably arise, generated by the tension between duties to the client and preservation of the attorney-client privilege, on the one hand, and a theory that, at least in some formulations, holds the attorney to the standard of "gatekeeper" and financial watchdog, on the other. Yet there is clearly no need for the Court to create new liabilities and ethical quandaries for practicing lawyers, since the question concerning when attorneys should be held responsible in private litigation for client fraud is resolved by

the Court's legal analysis in *Central Bank*. The Court in *Central Bank* rejected the legal underpinnings of the scheme liability theory as applied to false statements made by others, determining that § 10(b) simply does not support such a cause of action. Congress, moreover, has twice rejected the private right of action for aiding and abetting liability that Petitioner in effect seeks from the Court in the form of a scheme theory that would impose liability on secondary actors for fraudulent statements made by others. In 1995, Congress enacted the PSLRA, a statute that introduced a number of substantive and procedural reforms designed to curb abuses in security class action lawsuits. Notably, the Act restored the authority of the SEC to proceed against those who aid and abet securities fraud. Congress, however, declined to provide a private right of action against aiders and abettors of securities fraud. In 2002, Congress revisited the issue in the Sarbanes-Oxley Act. Once again, despite pressure to amend the 1934 Act to subject aiders and abettors to private lawsuits, Congress declined to do so. When congressional decisions to retain the status quo are made after active deliberation, this Court affords those decisions significance. *See, e.g., Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 378 n.13 (2000) ("The fact that Congress repeatedly considered and rejected targeting a broader range of conduct lends additional support to our view.").

Additionally, the SEC has ample authority to bring actions against attorneys for wrongdoing in their representation of public companies. First, the SEC may pursue an attorney by an action in federal district court seeking injunctive and other relief for aiding and abetting. *See, e.g., SEC v. Fehn*, 97 F.3d 1276 (9th Cir. 1996), *cert. denied*, 522 U.S. 813 (1997) (attorney violated Rule 10b-5 as aider and abettor when he reviewed and filed client's disclosure statements, knowing of material omissions). The SEC can also bring administrative cease-and-desist proceedings against attorneys who violate or are about to violate the securities laws. *See* Securities

Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990). Finally, the SEC, pursuant to Rule 102(e) of its Rules of Practice, 17 C.F.R. § 201.102(e) (2007), may deny an attorney, either temporarily or permanently, the right to appear and practice before the agency. Courts have recognized that a securities suit brought by the SEC has greater legitimacy than suits brought by private parties because the SEC "is a responsible governmental agency." *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 33 n.3 (D.C. Cir. 1987).

Notably, the Sarbanes-Oxley Act instructed the SEC to promulgate rules setting minimum standards for the attorneys who practice before the agency. *See* 15 U.S.C. § 7245 (Supp. II 2004). The SEC has issued regulations requiring attorneys, in prescribed circumstances, to "report up" the corporate hierarchy when there is evidence of wrongdoing by the officers, employees or agents of the company. A lawyer is now required to report to the client evidence that a material breach of the securities laws or a violation of fiduciary duties is "reasonably likely." 17 C.F.R. § 205.2(e) (2007). The triggering evidence is defined as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." *Id.* The rules, however, specifically recognize that an attorney owes his or her professional and ethical obligations to the corporate client, 17 C.F.R. § 205.3(a), and the rules do not create a private right of action against an attorney.[11] 17 C.F.R.

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[11] Further, under Rule 1.2, comment 10, ABA Model Rules of Professional Conduct, a lawyer may not "continue assisting a client in conduct that the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent." However, absent a red flag of some kind, an attorney has no duty of inquiry. ABA Committees have stated that a lawyer is not obligated to "carry on an investigation by searching out or developing facts and information beyond such as are already

§ 205.7. The reporting up duty, unlike Petitioner's scheme liability theory, is fully consistent with the attorney's duties of confidentiality and client loyalty.

III. SCHEME LIABILITY COULD ENCOURAGE ATTORNEYS TO DECLINE THEIR TRADITIONAL ROLES AS CLIENT ADVISORS.

Subjecting attorneys to "scheme" liability as "substantial participants" in misleading statements and/or omissions in an issuer's public filings, press releases and shareholder reports, even with no indication on the face of the documents of the lawyer's involvement, would have profoundly negative implications. One is that if attorneys could be targeted for little more than a failure to prevent client misconduct, or to fully disclose such misconduct to the public, a result that would follow from many of the court-crafted scheme liability tests, then well-counseled lawyers would decline to provide disclosure advice to troubled clients—precisely those who need it most—because of potential civil liability.

Moreover, opening the door to liability on a scheme theory, where even a lawyer's drafting suggestions might involve him in a lawsuit as a defendant, would send a clear signal to securities lawyers across the country that it is better to do nothing than to counsel a public company on difficult disclosures. As the SEC stated in *In re Carter*, No. 3-5464, 1981 WL 384414 (SEC Feb. 28, 1981), "[c]oncern about his own liability may alter the balance of [a lawyer's] judgment in one direction as surely as an unseemly obeisance to the wishes of his client can do so in the other. While one imbalance results in disclosure rather than concealment, neither

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available to him from the assigned legal work in which he is engaged." ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information, Second Report of the Committee on Audit Inquiry Responses Regarding Initial Implementation, 32 Bus. Law. 177, 180 (1976).

is, in the end, truly in the public interest." *Id.* at *25. A standard "which would permit a lawyer to avoid or reduce his liability simply by avoiding participation in the drafting process, may well have the undesirable effect of reducing the quality of the disclosure by the many to protect against the defalcations of the few." *Id.* at *24. Similar considerations apply to the legal work performed by transactional lawyers who are not even involved in advising on the clients' public financial disclosures.

This Court has recognized that "newer and smaller companies" often have difficulty obtaining high-caliber professional counsel because their "business failure would generate securities litigation against the professional." *Central Bank*, 511 U.S. at 189. Adoption of a scheme theory of secondary actor liability, because it would work an extraordinary expansion in the reach of implied private actions, could chill law firms from representing such companies as well as companies experiencing financial difficulties.

A vivid illustration of this phenomenon is the litigation aftermath of the savings and loan crisis of the 1980s. Although there was widespread evidence that macroeconomic trends, abnormal interest rate movements, and regulatory constraints were the driving factors in the collapse of the thrift industry, *see United States v. Winstar Corp.*, 518 U.S. 839, 845-48 (1996), the federal deposit insurance agencies and thrift regulators embarked on a campaign of lawsuits against directors of, and counsel for, many failed thrifts and banks. Recognizing that these suits were driven by a quest for their liability insurance, many commercial insurance carriers (although not ALAS) introduced "regulatory" and other exclusions in their policies that foreclosed insurance coverage for claims arising out of failed banks and thrifts. The federal courts of appeals rejected the argument that the regulatory exception violated public policy. *See Am. Cas. Co. v. FDIC*, 39 F.3d 633, 638-39 (6th Cir. 1994); *FDIC v. Am. Cas. Co. of*

Reading, Pa., Inc., 995 F.2d 471, 473 (4th Cir. 1993); *St. Paul Fire & Marine Ins. Co. v. FDIC*, 968 F.2d 695, 702 (8th Cir. 1992); *see generally*, John K. Villa, *Bank Directors', Officers', and Lawyers' Civil Liabilities*, § 4.09[B], at 4-49 (Supp. 1996) (discussing the exception and collecting cases). The inclusion of a regulatory exception caused many of the larger and well-advised law firms to avoid altogether representing troubled financial institutions and those that were in weakened financial condition—the group that one could argue most needed sound legal advice.[12] Whether or not one could defend the judgment of the deposit insurance officials in their litigation campaign against law firms that represented failed banks and thrifts, few believe that the plaintiffs' securities bar should be handed a comparable litigation weapon, *i.e.* scheme liability, that would achieve a similar result.

In sum, as a matter of both law and policy, the judgment of the Eighth Circuit should be affirmed. If that ruling were reversed and *Central Bank* abandoned, there would be widespread uncertainty about the reach of the securities laws, with significant detrimental consequences for attorneys and the companies they advise.

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[12] Ironically, the federal deposit insurance agencies turned to their pursuit of law firms only after their claims against thrift and bank directors had resulted in "regulatory exclusions" being introduced into most directors and officers liability insurance policies and "outside" directors had largely disappeared from the board rooms of troubled thrifts.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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IN THE
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR RICHARD I. BEATTIE, KENNETH J. BIALKIN, ARTHUR FLEISCHER, JR., JOSEPH H. FLOM, IRA M. MILLSTEIN, JACK H. NUSBAUM AND E. NORMAN VEASEY AS AMICI CURIAE SUPPORTING RESPONDENTS

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INTEREST OF AMICI CURIAE[1]

Amici Richard I. Beattie, Kenneth J. Bialkin, Arthur Fleischer, Jr., Joseph H. Flom, Ira M. Millstein, Jack H. Nusbaum and E. Norman Veasey are experienced transactional lawyers from a variety of prominent law firms.[2] Amici regularly represent financing counterparties to issuers, including underwriters, private equity firms and large financial institutions, in a wide range of financial transactions, including public and private offerings, structured finance, commodities and derivatives transactions, off-balance sheet financings, joint ventures, limited partnerships, mergers and acquisitions.

In connection with such transactions, amici often advise their clients in multiple ways, including negotiating, drafting and reviewing legal documents, assisting clients in their due diligence investigations and providing opinion letters. For years, amici have been providing legal advice to clients participating in complex structured finance and other financial transactions with public companies. That legal advice has, of course, derived from, *inter alia*, this Court's precedents regarding liability under Section 10(b) of the Securities Exchange Act of 1934 for actors who mislead the

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[1] Letters reflecting petitioner's blanket consent to the filing of amicus briefs and respondents' consent to the filing of this brief have been lodged with the Clerk of Court. No counsel for any party authored this brief in whole or in part, and no person or entity other than amici and their counsel has made a monetary contribution to the preparation or submission of this brief. Counsel of record for amici is also counsel of record for certain respondents in *Regents of the University of California v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 06-1341 (petition for cert. filed Apr. 5, 2007), which presents legal issues similar to those involved in this case.

[2] A list of amici, along with the law firms of which they are members, is included in an appendix hereto.

securities markets, and the bright-line rule for secondary actors that those precedents establish.

Amici have an interest in the outcome of this case because, if petitioner's theory of primary liability is accepted and § 10(b) private liability is extended to any secondary actor who participates in a transaction with an issuer that is alleged to have the "purpose and effect" of creating a "false appearance of material fact" in furtherance of a "scheme", the ability of amici, and numerous other lawyers practicing in these areas, to provide legal guidance to their clients based upon certain clear and predictable legal standards will be impaired. Amici accordingly submit this brief discussing this Court's decisions on "deceptive" conduct under § 10(b), and their inconsistency with petitioner's theory of "scheme" liability.

SUMMARY OF ARGUMENT

Petitioner and its amici urge this Court to expand private liability under § 10(b) to secondary actors who do not themselves commit any deception by making a material misstatement or breaching a duty to disclose, but who allegedly participate in a "scheme" with others, the "purpose and effect" of which is "to create a false appearance of material fact in furtherance of that scheme" by an issuer. (*E.g.*, Br. for Pet'r 15.) This invitation should be rejected.

Petitioner's proposed liability theory flatly contradicts decades of this Court's precedents firmly establishing a clear rule limiting liability under § 10(b) to those persons who themselves actually make a material misstatement (or omission in the face of a duty to disclose) or commit a manipulative trading practice. *See, e.g.*, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only

the making of a material misstatement (or omission) or the commission of a manipulative act.").

Indeed, the conspiracy-based theory of "scheme" liability advanced by petitioner is virtually indistinguishable from the aiding-and-abetting liability rejected by this Court in *Central Bank*, and if adopted would effectively nullify that decision. Petitioner's test would allow plaintiffs' lawyers to relabel conduct that was previously deemed aiding and abetting or conspiracy as "primary" participation in a fraudulent "scheme", and would even require a different result on the facts of *Central Bank* itself.

This Court's jurisprudence has consistently upheld a bright-line rule limiting deceptive conduct liability under § 10(b) to actors who actually make material misstatements (or omissions in breach of a duty to disclose)—notwithstanding numerous attempts to expand the statute by members of the plaintiffs' bar and even on occasion the Securities and Exchange Commission. Those precedents should not be lightly discarded. The judgment of the court of appeals should be affirmed.

ARGUMENT

I. THIS COURT HAS CONSISTENTLY LIMITED LIABILITY FOR "DECEPTIVE" ACTS UNDER § 10(b) TO THOSE ACTORS (WHETHER THEY BE ISSUERS OR SECONDARY ACTORS) WHO ACTUALLY MAKE A MISSTATEMENT OR VIOLATE A DUTY TO DISCLOSE.

A. Prior to *Central Bank*, This Court's Decisions Limited the Types of "Deceptive" Conduct Covered by § 10(b).

As the Eighth Circuit recognized, this Court's precedents have established three principles regarding the scope of § 10(b). *First*, the plain language of the statute

prohibits only "manipulative or deceptive" acts, and private plaintiffs may not bring actions under Rule 10b-5 for conduct not prohibited by the statute. *Second*, the term "manipulative", as used in the securities context, is a term of art referring to trading practices that artificially inflate the price of the traded security. *Third*, and most critically for this case, "deceptive" conduct, within the meaning of § 10(b), requires deception—namely, a misstatement or failure to disclose by one who has a duty to disclose. That is precisely why this Court held unequivocally in *Central Bank* that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act". 511 U.S. at 177.

Central Bank is firmly grounded in prior decisions demarcating the scope of § 10(b). As early as *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), this Court required a finding of a duty to disclose before imposing § 10(b) liability for deceptive conduct in the absence of an affirmative misrepresentation. That case involved a suit brought by Indian sellers of stock in a corporation formed to manage joint assets derived from tribal holdings. The corporation had designated a local bank as its transfer agent, and two of the bank's managers—Gale and Haslem—aided the Indian shareholders in selling their stock. The Indian sellers alleged that the bank and its two employees violated § 10(b) and Rule 10b-5 by failing to inform them about a resale market (created by Gale and Haslem) that offered higher prices.

The court of appeals concluded that Gale and Haslem were liable under Rule 10b-5 "only in those instances where the employee purchased shares for his own account or for resale . . . at a higher price". 406 U.S. at 149. This Court affirmed the court of appeals' judgment "to the extent that it held that the two employees had violated Rule 10b-5". The Court reasoned that, in those instances, the record revealed that Gale and Haslem made a misstatement of material fact in

violation of subparagraph (b) of Rule 10b-5—"namely, that the prevailing market prices of the . . . shares was the figure at which their purchases were made". *Id.* at 152. But the Court rejected the lower court's conclusion that "there was no violation of the Rule unless the record disclosed evidence of reliance on material fact misrepresentations by Gale and Haslem", finding instead that liability existed under subparagraphs (a) and (c) of the Rule, which were not limited to affirmative misrepresentations but extended also to a "course of business" or "device, scheme, or artifice to defraud". *Id.* at 152-53. Contrary, however, to the suggestions of petitioner and its amici that *Affiliated Ute* endorsed "scheme" liability in "conduct" cases without any misrepresentation or violation of a duty to disclose by the defendant,[3] the Court was explicit in noting that what made the employees' conduct fraudulent within the meaning of the statute and subparagraphs (a) and (c) of the Rule was the fact that Gale and Haslem breached an obligation to disclose:

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[3] (*See* Br. for Pet'r 30 (arguing that *Affiliated Ute* demonstrates "that Section 10(b) and Rule 10b-5 extend beyond misrepresentations and omissions"); Br. for Amicus Regents of Univ. of Cal. 27; Br. for Amicus Cal. State Teachers' Ret. Sys. 11; Br. for Amici L.A. County Employees Ret. Ass'n et al. 16; Br. for Amici Change To Win & CtW Inv. Group 24.) These arguments rely on a statement taken out of context from *Affiliated Ute* that "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact" but that "[t]he first and third subparagraphs are not so restricted", 406 U.S. at 152-53. The misstatements and omissions proscribed by Rule 10b-5(b) to which the Court was referring are only those of parties who actually speak—that is, those who "make any untrue statement of a material fact or . . . omit to state a material fact necessary in order to make *the statements made* . . . not misleading", 17 C.F.R. § 240.10b-5(b) (emphasis added)—not omissions by those who make no misleading statements but who have a duty to disclose. As discussed in the main text, the Court made clear that, even in an action for participation in a fraudulent "scheme" under Rule 10b-5(a) and (c), liability for deceptive conduct by those who remain silent will not lie absent the breach of a duty to disclose.

> "These defendants' activities . . . disclose, within the very language of one or the other of those subparagraphs, a 'course of business' or a 'device, scheme, or artifice' that operated as a fraud upon the Indian sellers. This is so because the defendants devised a plan and induced the [Indian sellers] to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell. The individual defendants, in a distinct sense, were market makers, not only for their personal purchases . . . but for the other sales their activities produced. This being so, they possessed *the affirmative duty under the Rule to disclose this fact* to the [Indian] sellers."

Id. at 153 (emphasis added) (citations omitted); *see also id.* (describing the case as "involving primarily a failure to disclose"). The Court left no doubt that it was this duty to disclose—arising from the special relationship between the parties—that formed the basis for liability. *See id.* at 151-52 ("We would agree that if the two men and the employer bank had functioned merely as a transfer agent, there would have been no duty of disclosure here.").[4] Informing the Court's decision was its recognition that the existence of the defendants' duty to disclose was necessary for the plaintiff sellers to be able to satisfy the reliance requirement of the § 10(b)/Rule 10b-5 private cause of action:

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[4] Indeed, this Court has since observed that *Affiliated Ute* established that "silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . *[b]ut such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction*". *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (emphasis added).

> "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. *This obligation to disclose* and this withholding of a material fact establish the requisite element of causation in fact."

Id. at 153-54 (emphasis added) (citations omitted).

Prior to *Central Bank*, the Court provided similar guidance regarding the reach of § 10(b) in *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), and *Chiarella v. United States*, 445 U.S. 222 (1980). In *Santa Fe*, minority shareholders in a company alleged that the majority shareholder violated Rule 10b-5 in conducting an unfair "short-form merger" transaction that eliminated minority shareholders, although full disclosure was made. The court of appeals reversed the district court's dismissal of the suit, holding that a Rule 10b-5 action could be premised on "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure". *Santa Fe*, 430 U.S. at 470. The court of appeals reasoned:

> "An[] erroneous assumption is that in order to allege a claim under Rule 10b-5 there must be some showing of misrepresentation or lack of disclosure. . . . But only subdivision [(b)] of 10b-5 deals with nondisclosure and misrepresentation. The Rule contains two other subdivisions which state explicitly that fraud other than and in addition to a failure to disclose or truthfully represent is also actionable . . . ."

Green v. Santa Fe Indus., 533 F.2d 1283, 1286-87 (2d Cir. 1976).

This Court reversed. Focusing on the text of the statute, the Court concluded that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception". *Santa Fe*, 430 U.S. at 473. Because "the complaint failed to allege a material misrepresentation or material failure to disclose", the Court found "inapposite the cases relied upon by [the plaintiffs] and the court below, in which the breaches of fiduciary duty held violative of Rule 10b-5 included some element of deception". *Id.* at 474-75. Nor could the alleged conduct be deemed manipulative, as that term "is 'virtually a term of art when used in connection with securities markets'" that "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity". *Id.* at 476 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)).

In *Chiarella*, the Court similarly considered the scope of liability under § 10(b), this time for trading on inside information. The defendant in that case—the employee of a financial printer that had been engaged to print announcements of corporate takeover bids—used his position to trade in the securities of target companies before the takeover attempts were made public. The trial court instructed the jury that it could convict Chiarella for participating in a "scheme to defraud" in violation of Rule 10b-5(a) and (c) if "he 'did not disclose material non-public information in connection with the purchases of the stock'", reasoning that "a 'scheme to defraud' is a plan to obtain money by trick or deceit and that 'a failure by Chiarella to disclose material, non-public information in connection with his purchase of stock would constitute deceit'". *Chiarella*, 445 U.S. at 236 (quoting the trial court's instructions) (alteration omitted).

This Court reversed Chiarella's conviction, holding that Chiarella's conduct could not be characterized as deception under the statute because he had made no misstatement and he had no duty to disclose:

> "[T]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from [Chiarella's] relationship with the sellers of the target company's securities, for [he] had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence."

Id. at 232. The Court refused to "recogniz[e] a general duty between all participants in market transactions to forgo actions based on material, nonpublic information", noting that "[f]ormulation of such a broad duty [would] depart[] radically from the established doctrine that duty arises from a specific relationship between two parties". *Id.* at 233.[5] Observing that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)", *id.* at 232, the Court admonished: "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Id.* at 234-35.

The Court thus made clear in *Santa Fe* and *Chiarella* that the scope of conduct prohibited by § 10(b) and Rule 10b-5 must be determined by close adherence to the statutory language. Because the statute prohibits only manipulation and deception, only those who actually

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[5] The Court's analysis in *Chiarella* disposes of the suggestions by petitioner's amici that "scheme" liability should be derived from some common law "duty" not to scheme. (*See, e.g.*, Br. for Amicus Regents of Univ. of Cal. 23 n.28; Br. for Amici Arkansas et al. 19-22; Br. for Amici Change To Win & CtW Inv. Group 21-22.)

manipulate—as that term of art is used in the securities context—or deceive—which, in the absence of a misrepresentation, requires a duty to disclose—can be held to violate § 10(b), even in cases premised on violations of Rule 10b-5(a) and (c). The Court applied these principles faithfully in its subsequent cases involving § 10(b). *See Dirks v. SEC*, 463 U.S. 646 (1983) (reversing insider trading conviction of "tippee" on the ground that, in the circumstances of the case, the tippee possessed no duty to disclose); *Schreiber v. Burlington N. Inc.*, 472 U.S. 1, 2, 8 (1985) (holding that "misrepresentation or nondisclosure is a necessary element of a violation of § 14(e) of the Securities Exchange Act", after analogizing to decisions under § 10(b) and concluding that, in light of the "congressional concern with disclosure which is the core of the Act", "[a]ll three species of misconduct, *i.e.*, 'fraudulent, *deceptive*, or manipulative,' listed by Congress are directed at failures to disclose" (emphasis added)).

B. *Central Bank* Directly Foreclosed the "Scheme" Theory of "Deceptive" Conduct Advanced by Petitioner.

At the same time that this Court was requiring fidelity to the statutory text, lower courts were relying on common law tort principles in imposing various forms of secondary liability—including aiding-and-abetting liability and conspiracy liability—on actors who did not themselves commit deceptive or manipulative acts but who allegedly had a connection with someone who did. Indeed, by the time this Court faced the question directly in *Central Bank*, virtually every court of appeals had permitted private actions for aiding and abetting a violation of § 10(b) and Rule 10b-5. *See Central Bank*, 511 U.S. at 192 n.1 (Stevens, J., dissenting) (collecting cases). Although the standards for such aiding-and-abetting liability varied across the Circuits, most courts required an independent securities violation by another actor, and "substantial assistance" and scienter on the

part of the alleged aider and abettor. *See, e.g., Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Woodward v. MetroBank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975).[6]

In an influential article repeatedly cited by the Court in *Central Bank*, Professor Fischel noted the apparent inconsistency between this Court's § 10(b) jurisprudence and the imposition of secondary liability by the lower courts, arguing that "the theory of secondary liability [under § 10(b)] is no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws". *See* Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80, 82 (1981). Professor Fischel concluded that this Court's precedents established that "defendants can be held liable, if at all, only if they have engaged in a 'manipulative or deceptive practice' prohibited by section 10(b)", and that "in order to fall within this statutory prohibition, a defendant, acting with scienter, must make a material misrepresentation or wrongfully fail to disclose despite a fiduciary duty to do so in connection with the purchase or sale of a security, or engage in a manipulative practice designed to mislead investors by artificially affecting market activity". *Id.* at 102-03.

That thesis was validated in *Central Bank*. The facts of *Central Bank* are now familiar: Purchasers of bonds issued by the Colorado Springs–Stetson Hills Public Building Authority filed suit under § 10(b) after the Authority defaulted on the bonds. The purchasers named, among

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[6] Similarly, when Congress responded to *Central Bank* in 1995 by expressly authorizing the SEC to bring actions for aiding and abetting (while specifically declining to permit such actions by private plaintiffs), it defined aiding and abetting as "knowingly provid[ing] substantial assistance" to a primary violator. 15 U.S.C. § 78t(e).

others, the Authority, the underwriters, and the Central Bank of Denver, which had served as indenture trustee for the issuance. The Tenth Circuit concluded that Central Bank could be held liable under § 10(b) for aiding and abetting the fraud by agreeing with certain other defendants to delay an independent appraisal of land that was established as the security for the bonds, despite having learned that an earlier appraisal on which the purchasers were relying was outdated and possibly inaccurate. *Central Bank*, 511 U.S. at 167-69.

In addressing whether such a claim for aiding and abetting was cognizable under § 10(b), the Court began by reviewing its precedents, observing that "our cases considering the scope of conduct prohibited by § 10(b) in private suits have emphasized adherence to the statutory language" and have "refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute". *Id.* at 173. Turning to the language of § 10(b), the Court "reach[ed] the uncontroversial conclusion, accepted even by those courts recognizing a § 10(b) aiding-and-abetting cause of action, that the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation". *Id.* at 177. Unlike those courts, however, the Court announced that "that conclusion resolves the case", observing that "[i]t is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text". *Id.* Synthesizing its prior decisions, the Court stated:

> "As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. The proscription does not include giving aid to a person who commits a manipulative or deceptive act."

Id. (citations omitted).

As in the *Affiliated Ute* decision, the Court noted that its conclusion was particularly supported in the context of a private civil suit under the § 10(b) implied cause of action because permitting aiding-and-abetting liability "would impose . . . liability when at least one element critical for recovery under 10b-5 is absent: reliance". *Id.* at 180. Because "[a] plaintiff must show reliance on the defendant's misstatement or omission to recover under 10b-5", permitting aiding-and-abetting liability would impermissibly allow a plaintiff to recover "without any showing that the plaintiff relied upon the aider and abettor's statements or actions" and would consequently "disregard the careful limits on 10b-5 recovery mandated by our earlier cases". *Id.*

Central Bank thus reaffirmed without any ambiguity that liability under § 10(b) is limited to those who *themselves* actually make a material misstatement or violate a duty to disclose, or who employ a manipulative device as that term of art has been interpreted. Indeed, as the dissent recognized, the majority's rationale "at the very least casts serious doubt" on *all* forms of secondary liability under § 10(b). *Id.* at 200 (Stevens, J., dissenting).[7] The elimination of secondary liability "does not mean", however, "that secondary actors in the securities markets are always free from liability under the securities Acts". *Id.* at 191. On the contrary, the Court made clear that

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[7] *See, e.g., Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 842 (2d Cir. 1998) ("[I]mplying a cause of action for conspiracy would be 'inconsistent with settled methodology in § 10(b) cases' for precisely the same reason that the Supreme Court refused to imply a cause of action for aiding and abetting in *Central Bank*—it would 'extend liability beyond the scope of conduct prohibited by the statutory text.'" (quoting *Central Bank*, 511 U.S. at 177)); *accord Glaser v. Enzo Biochem, Inc.*, 126 Fed. Appx. 593, 599 (4th Cir. 2005); *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995).

> "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met. See Fischel, 69 Calif. L. Rev., at 107-108."

Id. at 191 (emphasis in original). The Court's citation to Professor Fischel's article confirms that the sort of liability-producing conduct by a secondary actor that the Court had in mind, assuming all of the requirements for primary liability are met, was "the dissemination or transmission of materially inaccurate information to investors" by the secondary actor itself, such as "an accountant's act of certif[ying]" misleading financial statements or an attorney's "prepar[ation of] false opinion letters". Fischel, *supra*, at 107-08. Such a misstatement (or an omission, where there is a duty to disclose) by the secondary actor allows the plaintiff to prove reliance *on that defendant's* actions, an essential requirement of the Rule 10b-5 cause of action.

Petitioner's proposed test—which would impose liability on any person "if the purpose and effect of his conduct is to create a false appearance of material fact in furtherance of" "a scheme to defraud" (Br. for Pet'r 15)—thus cannot be reconciled with this Court's jurisprudence, as the court below correctly recognized. By extending liability to cases where the secondary actor defendant itself does not make a misstatement to investors and does not breach a duty to disclose (or engage in "manipulative" trading practices), petitioner's test lacks any grounding in the text of § 10(b). As in *Central Bank*, "that conclusion resolves the case", for "[i]t is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text". 511 U.S. at 177.

C. Petitioner's Theory of "Scheme" Liability Would Nullify *Central Bank*.

In addition to being unmoored from the language of the statute and, consequently, inconsistent with this Court's § 10(b) jurisprudence, petitioner's "scheme" theory of liability would effectively render *Central Bank* a nullity. Under petitioner's reasoning, "giving aid to a person who commits a manipulative or deceptive act", the precise conduct held to be outside the scope of § 10(b) in *Central Bank*, 511 U.S. at 177, would constitute a primary violation if done with the "purpose" to deceive. Thus, the exact conduct that was previously denominated as aiding and abetting—providing "substantial assistance", with scienter, to a primary violator—could in essentially every case be relabeled through artful pleading as "purposeful" participation in a "scheme to defraud".[8] For all practical purposes, *Central Bank* would be rendered a historical relic.

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[8] Claims against transaction counterparties like those against respondents here were pursued prior to *Central Bank* on the precise theory that participation in deceptive transactions constituted aiding and abetting. *See, e.g., K&S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 976 (8th Cir. 1991) (involving aiding-and-abetting claim against banks for making loans that enabled primary actors to "engage in a 'pyramid' scheme"); *Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301 (10th Cir. 1987) ("Plaintiffs also alleged that Fidelity Bank . . . aided and abetted in a conspiracy to promote the scheme by engaging in a fraudulent and deceptive transaction to create the false appearance to prospective investors that the Bradford Partnerships could and would obtain the COPP loans from Fidelity Bank."). Given petitioner's broad and subjective test for "scheme" liability, it appears that the only conduct that would be shielded from its reach would be that which would not even have constituted aiding and abetting before *Central Bank*, *i.e.*, non-intentional conduct. *See, e.g., Schatz v. Rosenberg*, 943 F.2d 485, 497 (4th Cir. 1991) (dismissing an aiding-and-abetting claim because "plaintiffs never allege[d] any facts tending to show an intent on [the law firm's] part to violate the securities laws").

Indeed, petitioner's theory would require a different result on the facts of *Central Bank* itself. As noted above, Central Bank was charged with "agree[ing] to delay" a new, independent appraisal of the collateral for a bond issuance for which it was serving as the indenture trustee, despite knowing of possible problems with the existing appraisal that the purchasers were using to evaluate the investment. *Central Bank*, 511 U.S. at 167-68. Central Bank's agreement with the issuer, which enabled it to issue otherwise unmarketable bonds, could easily be relabeled as conduct with the "purpose and effect" of deceiving investors in furtherance of a fraudulent "scheme". In fact, as the court of appeals in *Central Bank* noted, the plaintiffs in that case *did* "allege that the . . . bonds were sold as part of a fraudulent scheme". *First Interstate Bank of Denver v. Pring*, 969 F.2d 891, 895 (10th Cir. 1992); *see also In re Parmalat Sec. Litig.*, 414 F. Supp. 2d 428, 434-35 (S.D.N.Y. 2006) (allowing "scheme" claim for bank's knowing use of outdated valuation). This Court rejected liability nonetheless.

In an effort to distinguish the case, petitioner and its amici attempt to diminish the role of Central Bank in furthering the fraud in that case (*see, e.g.*, Br. for Pet'r 26), with some going so far as to claim that "the allegation against Central Bank was based on a failure to act, rather than on any active conduct" (Br. for Amici Cox et al. 9; *see also* Br. for Amici Adams & von Glahn 12-14), but these arguments ignore the actual record in that case. The court of appeals, for example, observed that the plaintiffs' claim against Central Bank was for violating the statute by "*affirmative action*, specifically by affirmatively agreeing to delay the independent review of the Hastings appraisal". *First Interstate Bank*, 969 F.2d at 902 (emphasis in original). The purchasers similarly asserted in their brief to this Court that the bank "provided critical assistance to the fraudulent scheme by taking affirmative steps to ensure that the shortage of collateral and the defects of the appraisal would be hidden

from plaintiffs and other potential purchasers". Brief for Respondents at 2, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 13006274; *see also* Brief for Amicus SEC at 19 n.18, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 13006275 ("[Central Bank's] retraction of its demand for an independent appraisal is unlike conduct that the courts have held to consist of mere silence and inaction.").

Apparently recognizing the inconsistency between their theory of "scheme" liability and this Court's decision in *Central Bank*, petitioner and its amici go to great lengths to trivialize the decision's import, characterizing its reasoning as "dicta" (Br. for Pet'r 28), describing its holdings as "*quite narrow*" (Br. for Amicus Regents of Univ. of Cal. 28-29), and even implying that it was wrongly decided and should be limited to its facts (Br. for Amici Adams & von Glahn 2). They argue that "*Central Bank* clearly—but merely—stands for the proposition that no aiding-and-abetting liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain 'aiding and abetting' language". (Br. for Amicus Regents of Univ. of Cal. 28.) But *Central Bank* was not merely about whether the words "aiding and abetting" appeared in § 10(b). Rather, the Court carefully examined its own precedents to determine the scope of conduct prohibited by § 10(b), concluding that private 10b-5 liability does not reach those who do not themselves commit deceptive acts on which the plaintiff has relied. *See Central Bank*, 511 U.S. at 177 ("As in earlier cases considering *conduct prohibited by § 10(b)*, we again conclude that *the statute prohibits only* the making of a material misstatement (or omission) or the commission of a manipulative act." (emphasis added)). If *Central Bank* is to have any meaning at all, this holding cannot be limited merely to prohibiting claims expressly denominated as "aiding and abetting" while allowing exactly the same allegations to be relabeled as conduct in furtherance of a "scheme". Nor can this holding regarding the *conduct* prohibited by § 10(b) be circumvented by focusing solely on

a defendant's "purpose" and "effects". Similarly, the necessary "showing that the plaintiff relied upon the aider and abettor's statements or actions" that *Central Bank* found to be lacking, 511 U.S. at 180, cannot now be ignored simply by redesignating the same conduct by the same defendants as conduct in furtherance of a "scheme".

The arguments now advanced by petitioner and its amici in support of "scheme" liability are indeed the very arguments advanced in support of aiding-and-abetting liability and rejected by the Court in *Central Bank*. The purchasers in *Central Bank*, for instance, seized on the "any person" and "indirectly" language of § 10(b)—like petitioner and its amici do here—to argue that § 10(b) should be applied "to a broad class of defendants". Brief for Respondents at 15, *Central Bank* 511 U.S. 164 (No. 92-854), 1993 WL 13006274; *see also* Brief for Amicus SEC at 8-9, *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 13006275. This Court, of course, rejected that argument, holding that a defendant must *itself* commit a deceptive or manipulative act to violate § 10(b), 511 U.S. at 175-76, and that the plaintiff "must show reliance on *the defendant's* misstatement or omission", *id.* at 180 (emphasis added).

The arguments advanced by the National Association of Securities and Commercial Law Attorneys ("NASCAT") (essentially, the plaintiff class action securities lawyers) in *Central Bank* further underscore the virtual identity between the "scheme" liability theory petitioner urges here and the aiding-and-abetting liability rejected in *Central Bank*. As amicus in support of the purchasers, NASCAT argued that because "[t]o knowingly render substantial assistance to a fraudulent course of conduct is, in essence, to participate in it", "[a]ll members of such a scheme are responsible". Brief for Amicus NASCAT at 4 (internal quotation marks omitted), *Central Bank*, 511 U.S. 164 (No. 92-854), 1993 WL 13006273. NASCAT further contended that the statute and rule went "far beyond imposing liability for

individual misrepresentations or omissions" and imposed liability for "knowingly participat[ing] in such a fraudulent practice or course of conduct". *Id.* *Central Bank* rejected these arguments as well, making clear that the statute's proscription of deceptive conduct "prohibits only the making of a material misstatement (or omission)". 511 U.S. at 177.

For these reasons, virtually every Circuit to address theories of liability like petitioner's, including the court below, has ruled that a secondary actor that neither makes a misstatement (or omission in the face of a duty to disclose) nor employs a manipulative device may not be held liable in a private action under § 10(b), even if it is alleged to have participated in some manner in a "conspiracy" or "scheme" to defraud. *See Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) ("[I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting . . . ." (internal quotation marks omitted)); *Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 388 (5th Cir. 2007) ("'[D]eceptive' conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose." (internal quotation marks omitted)), *petition for cert. filed sub nom. Regents of Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 75 U.S.L.W. 3557 (U.S. Apr. 5, 2007) (No. 06-1341); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004) ("[H]olding Ernst & Young liable for either its alleged implicit endorsement of the unaudited financial figures or for its failure to insist on a correction to these figures would effectively revive aider and abettor liability in contravention of the Supreme Court's holding in [*Central Bank*]. In *Central Bank*, the Supreme Court held that Section 10(b) 'prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.'"); *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992

(8th Cir. 2006) ("[A]ny defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5."); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) ("[W]e conclude that in order for accountants to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("In order for a secondary actor, such as a law firm or accounting firm, to be primarily liable under § 10(b), the Plaintiffs must show reliance on the defendant's misstatement or omission to recover under 10b-5." (internal quotation marks omitted)). Only the Ninth Circuit, in adopting a version of the standard that petitioner now urges this Court to endorse, has deviated from this otherwise unbroken line of appellate authority. *See Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), *petition for cert. filed sub nom. Avis Budget Group, Inc. v. Cal. State Teachers' Ret. Sys.*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560).

D. Since *Central Bank*, This Court Has Continued To Require a Misrepresentation or Breach of a Duty To Disclose by the Defendant Before Imposing § 10(b) Liability for "Deceptive" Conduct.

Contrary to petitioner's contentions that *Central Bank*'s holdings have been undermined by subsequent decisions, this Court has continued to require a misrepresentation or breach of a duty to disclose by the defendant itself before finding liability for "deceptive" conduct under § 10(b). For example, in *United States v. O'Hagan*, 521 U.S. 642 (1997)—consistent with *Affiliated Ute*, *Santa Fe*, *Chiarella* and

Central Bank—the Court explicitly conditioned liability under the "misappropriation theory" of insider trading[9] on the defendant's breach of his duty to disclose. Thus, the Court explained that "[d]eception through nondisclosure is central to the theory of liability for which the Government seeks recognition":

> "[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of the information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty."

Id. at 654-55. Consequently, "it was O'Hagan's failure to disclose his personal trading to [his client and law firm employer], in breach of his duty to do so, that made his conduct 'deceptive' within the meaning of § 10(b)". *Id.* at 660 (alterations and internal quotation marks omitted).[10]

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[9] "The 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *O'Hagan*, 521 U.S. at 652.

[10] Petitioner and its amici invoke *O'Hagan*'s statement that § 10(b) liability is not limited to situations where the "purchaser or seller of securities" itself is the subject of the defendant's allegedly deceptive conduct, 521 U.S. at 651, 664, arguing that *O'Hagan* undermines *Central Bank*'s holding that a secondary actor may be held liable under Rule 10b-5 only if it "employs a manipulative device or makes a material misstatement (or omission) *on which a purchaser or seller of securities relies*", 511 U.S. at 191 (emphasis added). (*See* Br. for Pet'r 27; Br. for

Amicus Regents of the University of California asserts (Br. 23) that the duty to disclose required by *Chiarella* and *O'Hagan* applies only to claims based on "a failure to speak" and not to claims based on "conduct". No such distinction appears in those cases. Both cases clearly involved conduct—trading in the market on inside information and misappropriating confidential information for personal gain, respectively—and indeed the conviction in *Chiarella* (reversed by this Court) was explicitly premised on participation in a "scheme to defraud" or "conduct . . . operating as a fraud" in violation of Rule 10b-5(a) and (c), *see* 445 U.S. at 236. *Affiliated Ute*, another case requiring a duty to disclose, likewise involved a fraudulent "course of business" or "device, scheme, or artifice" in violation of Rule 10b-5(a) or (c). *See* 406 U.S. at 153. All of these cases establish that, in the absence of a misstatement by the defendant, the relevant conduct that makes an "act", "artifice", "course of business", "contrivance", "device", "practice" or "scheme"—whatever label the plaintiff decides to pursue—"deceptive" within the meaning of § 10(b) must involve the breach by the defendant of its duty to disclose.

The Wharf (Holdings) Ltd. v. United International Holdings, Inc., 532 U.S. 588 (2001), similarly confirms the necessity of a misrepresentation or breach of a duty to disclose by the defendant for a finding of deceptive conduct. *Wharf* presented the question whether selling an option to

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Amici N.Y. State Teachers' Ret. Sys. et al. 20.) But while *O'Hagan*'s observation is correct in the context of the criminal prosecution involved in that case, it has no application to a private suit under the § 10(b) implied cause of action, for which this Court has imposed additional requirements—including that the plaintiff establish reliance on the defendant's conduct. The *O'Hagan* Court expressly recognized as much. *See* 521 U.S. at 664 ("*Central Bank*'s discussion concerned only private civil litigation under § 10(b) and Rule 10b-5, not criminal liability. *Central Bank*'s reference to purchasers or sellers of securities must be read in light of a longstanding limitation on private § 10(b) suits.").

buy stock while secretly intending never to honor the option constitutes conduct violating § 10(b). 532 U.S. at 589-90. Although the Court could have simply characterized this conduct as a fraudulent "scheme" or "practice", it instead based its finding of liability on the fact that the seller's "secret reservation was . . . a misrepresentation":

> "To sell an option while secretly intending not to permit the option's exercise is misleading, because a buyer normally presumes good faith. Cf., *e.g.*, Restatement (Second) of Torts § 530, Comment *c* (1976) ('Since a promise necessarily carries with it the implied assertion of an intention to perform[,] it follows that a promise made without such an intention is fraudulent')."

Id. at 596 (alteration in original).[11]

Most recently, *SEC v. Zandford*, 535 U.S. 813 (2002), in which a stockbroker secretly sold his clients' securities in order to steal the proceeds, explicitly premised § 10(b)

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[11] Petitioner and various amici assert that the Eighth Circuit's decision is inconsistent with the Court's reference in *Wharf* to "a misrepresentation (or other conduct forbidden by the Rule)", 532 U.S. at 594, as well as with the Court's statement that a Rule 10b-5 plaintiff "must show that the defendant used . . . one of the four kinds of manipulative or deceptive devices to which the Rule refers", *id.* at 593 (setting forth the text of the Rule with subparagraph (b) divided into two parts). (*See* Br. for Pet'r 30-31; Br. for Amicus Am. Ass'n for Justice 8-9; Br. for Amici N.Y. State Teachers' Ret. Sys. et al. 21.) As with the invocation of similar statements in *Affiliated Ute*, these arguments miss the point. *See supra* note 3. The Eighth Circuit appreciated that § 10(b) and Rule 10b-5 reach conduct beyond misrepresentations (and omissions that make statements already made misleading) covered by Rule 10b-5(b); it correctly noted that this Court's precedents also prohibit manipulative trading practices and omissions by those who remain silent but have a duty to disclose. *See Charter*, 443 F.3d at 990.

liability on the broker's breach of his fiduciary duty to disclose. Thus, although petitioner is correct (Br. 31) that this Court stated that "each time [the broker] exercised his power of disposition for his own benefit, that conduct, without more, was a fraud", 533 U.S. at 821 (internal quotation marks omitted), the Court made clear that "each [sale] was deceptive because it was neither authorized by, nor disclosed to, the [clients]", *id.* at 820-21. The Court explained:

> "[A]ny distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients. See *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (noting that 'silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b)' when there is 'a duty to disclose arising from a relationship of trust and confidence between parties to a transaction'); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S., at 153."

Id. at 823. Thus, the assertions of petitioner's amici that *Zandford* "confirms that liability can apply even in the absence of a material misstatement" (Br. for Amicus Cal. State Teachers' Ret. Sys. 9; *see also* Br. for Amici Change To Win & CtW Inv. Group 27; Br. for Amici N.Y. State Teachers' Ret. Sys. et al. 22; Br. for Amici Cox et al. 7) are beside the point. The decision below recognized—consistent with *Zandford*—that "deceptive" act liability may be premised on "a failure to disclose by one who has a duty to disclose", *Charter*, 443 F.3d at 990. The critical issue under *Zandford* was whether the defendant *either* made a misrepresentation *or* breached his fiduciary duty to speak; where—as in the present case—there is neither a misrepresentation by the secondary actor nor a breach by that actor of a fiduciary duty to disclose (or "manipulative"

trading practices), then this Court's precedents consistently lead to the conclusion that there is no § 10(b) liability.[12]

E. *Bankers Life* and *Herman & MacLean* Do Not Upset the Requirement that the Defendant Itself Make a Misstatement or Breach Its Duty To Disclose.

In addition to mischaracterizing several of the cases discussed above, petitioner and its amici mistakenly argue that isolated language from two early decisions—not addressing the meaning of "deceptive" conduct—somehow undermines this Court's subsequent interpretation of that term.

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[12] The suggestions of petitioner and its amici that *Zandford* expanded liability for deceptive conduct beyond misrepresentations and violations of a duty to disclose are belied by the fact that the question that was actually decided by the court of appeals, presented by the petition for certiorari and addressed by this Court was not whether the broker's conduct was "deceptive" under § 10(b)—which was undisputed—but only "whether the alleged fraudulent conduct was 'in connection with the purchase or sale of any security' within the meaning of the statute and the Rule". *Zandford*, 535 U.S. at 815; *see also SEC v. Zandford*, 238 F.3d 559, 564 (4th Cir. 2001) ("The precise issue before us is whether Zandford's alleged fraud is sufficiently connected to a securities transaction . . . ."); Petition for Writ of Certiorari at I, *Zandford*, 535 U.S. 813 (No. 01-147), 2001 WL 34092101 (stating question presented as "[w]hether a stockbroker's fraud is 'in connection with the . . . sale' of securities under [§ 10(b) and Rule 10b-5], when the stockbroker sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so" (ellipsis in original)); Brief for Respondent at 1, *Zandford*, 535 U.S. 813 (No. 01-147), 2002 WL 405094 ("The parties agree that the outcome turns on the proper interpretation of § 10(b)'s requirement that a deception be 'in connection with' a securities transaction."). In any event, as discussed in the main text, to the extent it discussed the fraud, the Court made clear that it was the broker's breach of his fiduciary duty that made his conduct deceptive.

For instance, petitioner and its amici misread isolated statements from the Court's early decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), as supporting their theory of "scheme" liability. (*See, e.g.*, Br. for Pet'r 30.) Although several securities transactions were involved in that case, the only transaction before the Court was one in which an officer of an insurance company and others caused the company to sell almost five million dollars of U.S. Treasury bonds and then misappropriated the proceeds. *See* 404 U.S. at 13 n.10. Despite allegations that "a majority of the board of directors of [the company] was deceived by misrepresentations of other members of the board and some of the defendants that the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value", the Second Circuit dismissed § 10(b) claims brought by the company's liquidator because there was no claim that "the full and fair market price was not paid for those bonds by their purchaser" and consequently the alleged "deception did not infect the subsequent sales transaction". *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 430 F.2d 355, 360 (2d Cir. 1970).

The question before this Court was not whether the defendants' conduct was "deceptive" within the meaning of the statute—there was no dispute that the insurance company was "allegedly deceived into authorizing th[e] sale by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value", *Bankers Life*, 404 U.S. at 8 n.1—but only whether that deception was covered by § 10(b) even though "the full market price was paid for those bonds". *Id.* at 9. Concluding that § 10(b) "is not", as the Second Circuit had held, "limited to preserving the integrity of the securities markets" but instead reaches all deceptive conduct "in connection with" the "sale" of a security , *id.* at 12 (internal quotation marks omitted), the Court held that § 10(b) encompassed the defendants' misrepresentation, by

which "the seller was duped into believing that it, the seller, would receive the proceeds", *id.* at 9. The Court expressly declined to consider the potential liability of secondary actor defendant Bankers Life. *Id.* at 13. This early case involving affirmative misstatements by defendants actually relied upon by the plaintiffs is not inconsistent with and does not detract from the Court's subsequent decisions interpreting deceptive conduct to require a misstatement or breach of a duty to disclose. Indeed, this Court has noted that *Bankers Life* is "inapposite" to cases where "there [is] no 'omission' or 'misstatement'". *Santa Fe*, 430 U.S. at 474-75 & n.15.

Nor does *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), assist petitioner. That case held simply that purchasers of registered securities could maintain a § 10(b) action against an accounting firm that had issued an opinion concerning financial statements contained in the registration statement and prospectus, "notwithstanding the express remedy for misstatements and omissions in registration statements provide by § 11 of the Securities Act of 1933". *Id.* at 377. Petitioner and its amici invoke a statement in a footnote in which the Court noted that if "purchasers in registered offerings were required to rely solely on § 11, they would have no recourse against [individuals who play a part in preparing the registration statement but who cannot be reached by § 11] even if the excluded parties engaged in fraudulent conduct while participating in the registration statement", *id.* at 386 n.22. (*See* Br. for Pet'r 30; Br. for Amici Arkansas et al. 26-27; Br. for Amici Cox et al. 7; Br. for Amicus N. Am. Sec. Adm'rs Ass'n 13-14.) Because the secondary actor defendant there had made actual misrepresentations upon which the plaintiffs could rely—conduct that is unquestionably deceptive—the Court had no occasion in this pre-*Central Bank* case to expound further on the scope of "fraudulent conduct" under § 10(b).

Thus, neither *Bankers Life* nor *Herman & MacLean* is inconsistent with the long line of precedents, discussed

above, upon which the Eighth Circuit properly relied in affirming the dismissal of § 10(b) claims against the secondary actor defendants in the absence of any misrepresentations by those defendants and of any fiduciary duty to disclose by those defendants.

II. PETITIONER'S VAGUE "SCHEME" LIABILITY THEORY WILL HINDER THE ABILITY OF LAWYERS TO REPRESENT CLIENTS WHO DO BUSINESS WITH ISSUERS.

This Court has repeatedly recognized that the legal standard for private liability under the securities laws is "'an area that demands certainty and predictability'"; "'a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5' is not a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions'". *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988), and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975)) (alteration in original). Vague tests for liability under § 10(b) "lead[] to the undesirable result of decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services in the securities business", and consequently force defendants "to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial". *Id.* at 188-89 (quoting *Pinter*, 486 U.S. at 652); *see also Credit Suisse Sec. (USA) LLC v. Billing*, 127 S. Ct. 2383, 2394-97 (2007) (discussing the disadvantages of rules creating "complex, sinuous line[s] separating securities-permitted from securities-forbidden conduct").

The Court's decisions interpreting § 10(b)'s prohibition of "deceptive" conduct have heeded these concerns, establishing a clear rule as discussed above confining private liability to those situations where the defendant itself has made a material misstatement or breached its duty to disclose

to the plaintiff. Petitioner's vague theory of "scheme" liability, by contrast, would expose companies who do business with issuers to § 10(b) litigation whenever a plaintiff can plausibly allege that the counterparty's conduct had the "purpose and effect" of furthering the issuer's "fraudulent scheme". Such "scheme" allegations—always made in hindsight, after something bad has happened at the issuer—may be too readily made, particularly in a business environment in which transactions are frequently complicated and the applicable accounting principles are continuously evolving and require numerous judgment calls.

Such a vague standard of liability will impose particular burdens on transactional lawyers who, like amici, represent an issuer's counterparties. If petitioner's standard of liability is adopted, counterparties and their lawyers could be called upon to determine if the issuer—not the secondary actor client—intends to or could conceivably use the transaction to create a "false appearance of material fact". That determination would add a substantial burden to those lawyers and their counterparty clients, potentially requiring them not only to delve into the business affairs of the issuer, but also to review the work of the issuer's own advisors, including its accountants and lawyers. Such review could require expertise that transactional lawyers usually do not have, including expertise necessary to determine independently the proper accounting treatment for a complex, "cutting edge" transaction.

This is not a situation in which the counterparty client itself is making a statement (which counsel can review), or has a duty to disclose (on which counsel can advise). The counterparty client normally is not involved whatsoever in preparing or commenting upon the (audited) financial statements that constitute the alleged misstatement of the issuer. Rather, the counterparty client is engaged in a commercial transaction with the issuer; the issuer and *its* advisors (*its* lawyers and accountants) will ultimately

determine what the issuer should disclose regarding the transaction. The broad "scheme" liability theory advanced by petitioner potentially could force counsel for the counterparty client somehow to insert himself or herself into the issuer's disclosure discussions and decisions, or leave the counterparty client exposed to potential litigation for a decision by the issuer that the counterparty client ultimately had no ability to control.

There is no question that a vague, expansive theory of private liability for secondary actors places substantial burdens on the ability of counsel to advise their clients on prospective complex transactions, and could lead both to substantially higher transaction costs for clients and issuers and to a natural reluctance to proceed with financing transactions with new or potentially financially troubled issuers. A clear and predictable rule for liability of secondary actors, which amici believe is already found in this Court's precedents, places the burdens where they belong—on each actor and its own advisors—and is the most efficient means of ensuring a fair and open securities market.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed.

August 15, 2007

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR BUSINESS ROUNDTABLE AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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IN THE

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ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR BUSINESS ROUNDTABLE AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

INTEREST OF AMICUS CURIAE[1]

Business Roundtable is an association of chief executive officers of leading U.S. companies. The companies represented have $4.5 trillion in annual revenues and more than 10 million employees and comprise nearly one third of the total value of the U.S. stock market. Business Roundtable was founded in 1972 to increase the role of business execu-

[1] Pursuant to Rule 37.6 of the Rules of this Court, amicus states that no counsel for a party authored this brief in whole or in part. No person or entity, other than amicus or its members, made any monetary contribution to the preparation or submission of this brief. Petitioner has filed a letter with the Clerk of Court giving blanket consent to the filing of all amicus curiae briefs in this case. A letter of consent from respondents has been filed in the Court with this brief.

tives in public policy debates and to advance the goals of economic growth, a dynamic global economy, and a workforce capable of future competitiveness. Since its founding, Business Roundtable has conducted research, authored numerous white papers addressing a range of significant corporate matters, and lobbied Congress on such issues. It regularly files amicus curiae briefs in cases raising legal issues of significance to its members.

The question presented in this case is of great importance to Business Roundtable. The Court is asked to determine whether there is a private right of action under § 10(b) of the Securities Exchange Act of 1934 for "scheme liability." By extending the reach of liability to companies that made no misstatement (or omission) on which the plaintiffs relied, "scheme liability" would be a broad expansion of the private right of action under § 10(b). Because it is a particularly uncabined form of liability, it would increase the risk of frivolous lawsuits aimed at extracting settlements—a form of vexatious litigation against which Congress and this Court have sought to guard. The increased scope of liability and the threat of meritless suits threaten the interests of Business Roundtable, its members, and the companies that its members lead.

SUMMARY OF ARGUMENT

Neither § 10(b) of the Securities Exchange Act of 1934 nor SEC Rule 10b-5 promulgated thereunder explicitly mentions private civil liability, and this Court has often stated that neither Congress nor the Commission intended to create a right of action for private litigants. Nevertheless, decades ago, the courts implied such a right of action for material misstatements or omissions on which a plaintiff investor relied, provided that the plaintiff can establish that the misstatement or omission caused a loss. In this case, petitioner asks this Court to extend the § 10(b) private right of action to reach a new set of defendants: participants in a "scheme to defraud." Under petitioner's view, persons who themselves did not employ a deceptive device on which a plaintiff relied could be held liable if they knowingly contributed to

another person's violation. This broad expansion should be rejected because it would extend liability beyond the persons and conduct covered by the text of the statute and would substantially increase the dangers of vexatious litigation.

This brief will not make all of the arguments in opposition to petitioner's proposed new form of § 10(b) liability but will instead focus on two issues.

1. The courts created the § 10(b) private right of action without any consideration, or evidence, of congressional intent to authorize private enforcement of this antifraud provision. The Court has long since acquiesced in the existence of the private right, even as it has repeated that the right of action would not be "implied" today if the question were presented now for the first time. The Court should not extend the private right into new territory without any indication that Congress has authorized or approved such an extension. In practice, this Court has repeatedly declined to expand the private right of action, stressing both its nonstatutory origins and the high potential for vexatious litigation that Rule 10b-5 actions present. Expansion of the private right of action to reach the boundless class of "scheme" participants that did not themselves engage in any deceptive device would seriously exacerbate that risk.

Petitioner's suggestion that § 10(b) be read to authorize private actions for "scheme" liability is inconsistent with the securities laws as written by Congress and prior decisions of this Court. The text of § 10(b) describes persons who engage in deceptive devices on which investors rely. But petitioner here seeks to hold liable entities that concededly did not engage in any deceptive device—*i.e.*, made no misrepresentation (by words or actions) or omission—on which petitioner relied. *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994), rejected a similar extension of the private right of action to aiders and abettors, "conclud[ing] that the statute prohibits only the making of a material misstatement." *Id.* at 177.

Moreover, Congress, in response to *Central Bank*, made clear that it did not want to provide a § 10(b) private right of action against persons that did not themselves make misstatements or omissions on which investors relied. After *Central Bank*, the SEC and certain professional groups urged Congress to extend the § 10(b) private right of action to reach aiders and abettors. Congress refused but gave the SEC public enforcement authority against aiders and abettors. At the same time, Congress also placed additional limits on private § 10(b) suits in an effort to mitigate the risks of abusive litigation.

The "schemers" covered by petitioner's theory would include most or all of the aiders and abettors that this Court and Congress already found beyond the reach of § 10(b) and would also include a limitless range of additional persons who dealt with the person making the misstatement or omission in any way that a plaintiff can allege knowingly advanced the "scheme." Moreover, "scheme liability" as a legal concept is largely undefined; current requirements to state a cause of action under § 10(b)—including concrete allegations of materiality, reliance, and causation—would not translate to the "scheme" context, and the concept of a "scheme" is less well defined in the law than aiding and abetting. The courts would thus be required to create a new framework of requirements. In the meantime, the uncertainty as to the scope of liability would aggravate litigation abuses, increasing the pressure to settle. Congress's rejection of the request by the SEC and others to extend private liability to aiders and abettors forecloses the even broader judicial expansion sought here.

Finally, creation of private "scheme liability" would also be inconsistent with the express causes of action in the securities laws to which the Court has looked for guidance in defining the contours of the § 10(b) private right of action. In particular, each of the express causes of action carefully limits the scope of persons subject to liability and none would extend so broadly to reach those who participated in an ill-defined way in the illegal conduct at issue.

2. Petitioner and certain amici have argued that the SEC's support for "scheme liability"—as expressed in amicus briefs in other cases—should play a major role in this Court's determination of the question presented. Contrary to these suggestions, the Court does not owe deference to the SEC's amicus positions on this legal issue.

First, deference to agency views is appropriate only where Congress has not spoken to the precise question at issue. Here, Congress has made its intent clear: in the wake of *Central Bank*, Congress rejected the SEC's request to extend private liability beyond those who themselves engaged in deceptive devices on which plaintiff investors relied. Second, agency deference is predicated on the delegation of authority to the agency to interpret the statute on the point at issue. Here, Congress has plainly given no such authority to the SEC: since Congress never intended the private right of action, it certainly did not give the SEC the authority to determine its contours. And this Court has made clear that it will not infer a congressional delegation of authority to an agency to create or extend a judicial cause of action not created or extended by the statute itself.

ARGUMENT

I. THE PRIVATE RIGHT OF ACTION UNDER § 10(b) IS A JUDICIAL CREATION THAT SHOULD BE NARROWLY CONSTRUED TO REJECT "SCHEME LIABILITY"

A. The Implied Private Right Of Action Was Created Under A Practice The Court Has Since Abandoned

Petitioner asks the Court to extend the private right of action under § 10(b) of the Securities Exchange Act and Rule 10b-5 to reach participants in a "scheme to defraud," *i.e.*, persons who did not themselves employ a deceptive device on which plaintiff relied. But the private right of action under this antifraud provision is itself a judicial creation of a kind the courts would not engage in today, and for the same reasons the courts would not today create the right of action from scratch, they should not now extend it into new territory.

This Court has detailed the origins of the implied right of action under § 10(b) and Rule 10b-5. *See, e.g., Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 (1983). Neither the statute nor the Commission's rule makes any mention of actions by private parties. A district court first found an implied private right of action in 1946. *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). Many other courts followed, and this Court ultimately endorsed the approach in *Superintendent of Ins. of N.Y.* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). But the Court has repeatedly recognized that the private right of action was solely the creation of the Judicial Branch: "[W]e have made no pretense that it was Congress' design to provide the remedy afforded." *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350, 358-359 (1991). The Court has repeatedly described the private right of action as a "'judicial oak which ha[d] grown from little more than a legislative acorn.'" *Merrill Lynch, Pierce, Fenner & Smith* v. *Dabit*, 547 U.S. 71, 126 S. Ct. 1503, 1510 (2006) (quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975)) (alteration in original); *see also Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988) (explaining that the Court continued the private right of action because of "legislative acquiescence and the passage of time"); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 196 (1976) ("[T]here is no indication that Congress or the Commission, when adopting Rule 10b-5, contemplated such a remedy." (footnotes omitted)).

If the question whether to imply a private right of action under § 10(b) were to arise from scratch today, it is clear that the Court's answer would be "no," and it is inconceivable that the Court would "confirm[] with virtually no discussion ... that such a right of action did exist." *Blue Chip Stamps*, 421 U.S. at 730 (citing *Superintendent of Ins.*, 404 U.S. at 13 n.9; *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 150-154 (1972)). As Justice Scalia has put it, "[T]he contours of a Rule 10b-5 action" were initially "'implied' (*i.e.*, created) by the Court itself—a practice we have since happily abandoned[.]" *Holmes* v. *Securities Investor*

Protection Corp., 503 U.S. 258, 289 (1992) (Scalia, J., concurring in judgment) (citing *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 568-571, 575-576 (1979)).

This Court's more recent cases have consistently held that "any private right of action for violating a federal statute must ultimately rest on congressional intent to provide a private remedy." *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1102 (1991) (citing *Redington*, 442 U.S. at 575). In *Alexander* v. *Sandoval*, 532 U.S. 275 (2001), the Court found no private right of action under § 602 of Title VI of the Civil Rights Act of 1964, 78 Stat. 252, as amended, 42 U.S.C. § 2000d *et seq.*, to enforce regulations promulgated by the Department of Justice pursuant to that section. The Court said:

> Like substantive federal law itself, private rights of action to enforce federal law must be created by Congress . . . . The judicial task is to interpret the statute Congress has passed to determine whether it displays an intent to create not just a private right but also a private remedy. Statutory intent on this latter point is determinative. Without it, a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute.

Sandoval, 532 U.S. at 286-287 (citations omitted); *see also California* v. *Sierra Club*, 451 U.S. 287, 297 (1981) ("The federal judiciary will not engraft a remedy on a statute, no matter how salutary, that Congress did not intend to provide."); *Pharmaceutical Research & Mfrs. of Am.* v. *Walsh*, 538 U.S. 644, 683 (2003) (Thomas, J., concurring in judgment) ("[P]rivate parties may employ . . . an implied private right of action only if they demonstrate an 'unambiguously conferred right.'") (quoting *Gonzaga Univ.* v. *Doe*, 536 U.S. 273, 283 (2002)); *Redington*, 442 U.S. at 578 ("The ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme.").

It follows directly from this abandonment of the practice of implying rights of action Congress itself has never authorized, that the Court should not *extend* a right of action into new territory without any indication that Congress wished to go there. "Scheme liability" represents just such an extension, to persons and actions that are not mentioned in the statute.

B. While Never Abandoning The § 10(b) Implied Private Right Of Action, The Court Has Repeatedly Declined To Extend It

Prior to the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 ("PLSRA"), "Congress . . . had no occasion to provide guidance about the elements of a private liability scheme [under § 10(b)]," *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994), so the particular features and contours of the § 10(b) right of action had been almost entirely "of judicial creation," *Lampf*, 501 U.S. at 358. As this Court explained, "[w]e are dealing with a private right of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." *Blue Chip Stamps*, 421 U.S. at 748-749. The Court has approached this task cautiously, noting that it is ultimately not the Court's, but rather "the federal lawmaker's prerogative ... to allow, disallow, or shape the contours of—including the pleading and proof requirements for—§ 10(b) private actions." *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

The Court has therefore noted that "the breadth of [a] right once recognized should not, as a general matter, grow beyond the scope congressionally intended." *Sandberg*, 501 U.S. at 1102. In the context of a right of action entirely lacking a foundation in congressional intent, such as the § 10(b) private right of action, *any* expansion of the claim is necessarily beyond the scope that Congress intended. As a practical matter, of course, the courts must fill the interstices of a previously recognized right of action. *See, e.g., Lampf*, 501 U.S. at 359 (selecting a statute of limitations for actions

brought under § 10(b)). But when asked to endorse attempts to expand the class of persons and conduct for which judicially-implied causes of action are available, the answer must be "no."

In fact, the Court has repeatedly cabined the implied private right of action under § 10(b) since first recognizing it. *See, e.g., Blue Chip Stamps*, 421 U.S. at 737 (limiting the private right to purchasers and sellers); *Ernst & Ernst*, 425 U.S. at 193 (requiring that private actions brought under Rule 10b-5 require "'scienter' : . . intent to deceive, manipulate, or defraud"); *Sandberg*, 501 U.S. at 1104-1105 (rejecting respondents' theory of causation and noting that "[t]his is not the first effort in recent years to expand the scope of an action originally inferred from the Act without conclusive guidance from Congress."); *Central Bank*, 511 U.S. at 188-189 (concluding that Rule 10b-5 does not provide a private right of action against aiders and abettors).

The Court has read the § 10(b) right of action narrowly not only because of the lack of congressional authorization but also out of concern "that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. As the Court explained, "in this type of litigation ... the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits ... but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial[.]" *Id.* at 742-743.

These policy considerations underlie many other decisions of this Court concerning the scope of conduct actionable under § 10(b) and the elements of such claims. In holding that a Rule 10b-5 private plaintiff must allege scienter, "a mental state embracing intent to deceive, manipulate or defraud," the Court pointed to the procedural restrictions on the express civil remedies in the 1933 Act that allowed for recovery for negligent conduct and explained that "one of

the purposes" of those restrictions "was to deter actions brought solely for their potential settlement value." *Ernst & Ernst*, 425 U.S. at 210 n.30. More recently, the Court explained that a private plaintiff's expansive approach to allegations of loss causation under Rule 10b-5 "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the discovery process will reveal relevant evidence.'" *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 347 (2005) (quoting *Blue Chip Stamps*, 421 U.S. at 741) (alteration incorporated); *see also Sandberg*, 501 U.S. at 1104-1105 (rejecting respondents' theory of causation after recalling *Blue Chip Stamps* and expressing concern about "the same threats of speculative claims"); *Piper* v. *Chris-Craft Indus., Inc.*, 430 U.S. 1, 40 (1977) ("More likely is the prospect that shareholders may be prejudiced because some tender offers may never be made if there is a possibility of massive damages claims for what courts subsequently hold to be an actionable violation."); *TSC Indus., Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976) (rejecting the materiality standard petitioner urged because it was "too suggestive of mere possibilty" and might force management to make decisions out of "fear of exposing itself to substantial liability" "for insignificant omissions or misstatements").

Similar concerns animated this Court's decision in *Central Bank*. There, the Court considered petitioner's request to extend the reach of the § 10(b) private right of action to aiders and abettors. Rejecting that invitation, the Court repeated that "litigation under 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." 511 U.S. at 189. The Court cautioned, moreover, that such litigation "requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Id.*; *see also Tellabs, Inc.*, 127 S. Ct. at 2509 (explaining that "[p]rivate securities fraud actions, if not adequately contained, can be employed abusively to impose substantial cost

on companies and individuals whose conduct conforms to the law").

This concern over vexatious litigation is also consistent with the Court's more limited views of private securities actions as compared to SEC enforcement actions, in which abuse is much less of a concern. In *Aaron* v. *SEC*, 446 U.S. 680 (1980), the Court addressed SEC enforcement authority under § 10(b) as well as § 17(a) of the 1933 Act. Notwithstanding that the language of § 17(a) is almost identical to that of Rule 10b-5, and the Court's conclusion that all claims under § 10(b) require an allegation of scienter, the Court determined that the SEC could premise an enforcement action under subsections § 17(a)(2) and § 17(a)(3) based on negligence. *Id.* at 697. Although the SEC may bring claims under § 17(a) based on mere negligence, the Court has refused to permit private claims under § 17(a). *See Redington*, 442 U.S. at 578.

These cases reflect the Court's conclusion that the dangers of vexatiousness inherent in § 10(b) litigation necessitate particular judicial vigilance in crafting the contours of § 10(b) liability. Petitioner's "scheme liability" would substantially increase the risk of vexatious litigation that has previously concerned this Court.

C. "Scheme Liability" Would Reach Beyond The Classes Of Persons And Conduct Covered By The Statute And Prior Decisions Of This Court

The reasons for this Court's refusal to expand the § 10(b) private cause of action that the courts created are particularly powerful here, given that "scheme liability" would expand liability beyond the classes of persons and conduct covered by the text of the statute. Section 10(b) is concerned with intentional deception of investors who rely on the deception, and the Court has recognized an implied private right of action by such investors against the deceivers on whom they relied. But when litigants have attempted to extend the reach of § 10(b) liability beyond that core—whether to negligent actors, *see Ernst & Ernst*, or to aiders

and abettors, *see Central Bank*—this Court has repeatedly rejected their claims.

A "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)," *Central Bank*, 511 U.S. at 173, which makes it unlawful "[t]o use or employ, in connection with the sale of any security . . . any manipulative or deceptive device or contrivance." As this Court described in *Central Bank*, the implied private civil liability under § 10(b) for "those who commit a manipulative or deceptive act in connection with the purchase or sale of securities" has never been extended to allow suit where the plaintiff cannot "show reliance on the defendant's misstatement or omission." *Id.* at 167, 179; *see also Lampf*, 501 U.S. at 376-377 (noting that a private action under § 10(b) requires proof of a false or misleading statement, reliance, and causation).

Although petitioner has packaged its claim artfully, the type of conduct of which it complains cannot fit within the bounds of the present § 10(b) right of action. Instead, by asking this Court to extend liability to parties who "themselves made no public statements [or omissions and engaged in no expressive conduct] concerning those transactions," Pet. Br. i., and therefore to parties on whom petitioner cannot have relied, petitioner requests a judicial expansion of private liability to parties and conduct never intended by Congress. In *Central Bank*, the Court refused to recognize a similar extension after looking to "earlier cases considering conduct prohibited by § 10(b)" and "again conclud[ing] that the statute prohibits *only* the making of a material misstatement." 511 U.S. at 177 (emphasis added). The Court also explained that its "reasoning [was] confirmed by the fact that [plaintiffs'] argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance." *Id.* at 180. After all, a private plaintiff bringing claims for aiding and abetting under § 10(b) could not meet the requirement of demonstrating "reliance on *the defendant's* misstatement or omission to recover under 10b-5." *Id.* at 180. "Having sworn off the

habit of venturing beyond Congress's intent," this Court should not accept petitioner's "invitation to have one last drink." *Sandoval*, 532 U.S. at 287.

D. Congress's Response To *Central Bank* Also Supports A Narrow Interpretation Of The Implied Private Right Of Action Under § 10(b) To Exclude "Scheme Liability"

Legislation in the wake of *Central Bank* reinforces the conclusion that the private right of action under § 10(b) should not be extended to "scheme liability." After *Central Bank*, Congress considered proposals to override that decision and expand the private right of action by adding private liability for aiding and abetting. In enacting the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 ("PSLRA"), however, Congress rejected those proposals and chose to authorize only *SEC* enforcement against aiders and abettors and not private claims, *see id.* § 78t(e). Far from expanding the private right of action, the PSLRA and legislation that followed recognized the same concerns expressed by this Court about abusive § 10(b) litigation and took steps to restrict private suits under the statute. *See, e.g., id.* § 78u-4(b). On the question presented here, the Court need not "attempt to infer 'how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.'" *Central Bank*, 511 U.S. at 178 (quoting *Musick, Peeler, & Garret* v. *Employers Ins. of Wasau*, 508 U.S. 286, 294 (1993)). Congress has confirmed that *private claims* (as opposed to civil enforcement actions by the SEC) should not extend to persons who did not themselves engage in the deception on which the plaintiff investors relied.

Following *Central Bank*, the SEC argued to Congress that private liability under § 10(b) should be extended to aiders and abettors. Chairman Arthur Levitt testified to Congress that, in light of *Central Bank*:

> Persons who knowingly or recklessly assist the perpetration of a fraud may be insulated from liability to private parties if they act behind the scenes

> and do not themselves make statements, directly or indirectly, that are relied upon by investors. Because this is conduct that should be deterred, Congress should enact legislation to restore aiding and abetting liability in private actions.

S. Rep. No. 104-98, at 49 (1995). Groups including the North American Securities Administrators Association and the Association of the Bar of the City of New York agreed with the SEC that Congress should create private aiding and abetting liability. *See id.* The Senate Report on the PSLRA noted that when Congress chose not to add private aiding and abetting liability to the draft bill, Chairman Levitt submitted a letter "express[ing] his disappointment" that such liability was not added. *Id.* at 48.

Notwithstanding the SEC's urgings, Congress chose not to expand the scope of the private right of action under § 10(b). Congress recognized the role of private suits in complementing SEC enforcement as ensuring the "integrity and efficiency of our markets," S. Rep. No. 104-98, at 8, but the PSLRA rejected "the recommendation made by the SEC, the State securities regulators and the bar association that aiding and abetting liability be fully restored for the SEC and private litigants as well," *id.* at 48. It did so because "private aiding and abetting liability actions under Section 10(b) would be contrary to [the PSLRA's] goal of reducing meritless securities litigation." *Id.* at 8, 19.

The Senate Report recognized the coercive effects of such suits:

> The dynamics of private securities litigation create powerful incentives to settle, causing securities class actions to have a much higher settlement rate than other types of class actions. Many such actions are brought on the basis of their settlement value. The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim.

S. Rep. No. 104-98, at 6. Even Chairman Levitt conceded that "investors and markets are being hurt by litigation excesses." *Id.* at 5.

Motivated by the same concerns about vexatious litigation that this Court has identified, *see supra* pp. 9-11, Congress took other steps in the PSLRA "to curb frivolous, lawyer-driven litigation," *Tellabs*, 127 S. Ct. at 2509. Not only did Congress refuse to extend the private right of action under § 10(b), but it also imposed several additional "requirements for securities fraud actions," 15 U.S.C. § 78u-4(b). In particular, the PSLRA imposed heightened pleading requirements for the allegations of misstatements and omissions and allegations of the required state of mind. *Id.*

The PSLRA did, however, grant enforcement authority against aiders and abettors to the SEC. S. Rep. No. 104-98, at 48. Section 20(e) of the Securities Exchange Act, 15 U.S.C. 78t(e), now provides:

> Prosecution of persons who aid and abet violations
>
> For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78u(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

Congress's chosen approach balances competing interests, giving the SEC but not private plaintiffs the power to act against parties who did not themselves make a material misrepresentation or omission on which investors relied, so that—in cases deemed appropriate by the expert agency—action can be taken to deter and compensate for fraudulent conduct, but there is no encouragement to private, lawyer-driven, and often meritless litigation. The PSLRA thus reflects Congress's own determination that concerns about abusive litigation outweighed the benefits of allowing private claims against aiders and abettors and that SEC enforcement is sufficient. As this Court has explained, "[t]he

express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others." *Sandoval*, 532 U.S. at 290; *see also Massachusetts Mut. Life Ins. Co.* v. *Russell*, 473 U.S. 134, 147 (1985) (when "a statute expressly provides a particular remedy or remedies, a court must be chary of reading others into it" (internal quotation marks omitted)).

When Congress has revisited the issues implicated by the PSLRA, moreover, it has declined to expand the scope of the private right of action under § 10(b).[2] To the contrary, in the period since the PSLRA's enactment, legislation regarding private actions under § 10(b) has focused on shoring up the protections against vexatious litigation. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227; *Dabit*, 126 S. Ct. at 1510-1512 (detailing Congress's response through SLUSA to litigants' efforts to frustrate the goals of the PSLRA).

Allowing an expansion of private rights of action under a "scheme liability" theory would disrupt the balance that Congress has struck. Petitioner seeks the creation of a private right of action to remedy respondents' alleged acts; the acts alleged, however, do not include misstatements or omissions on which petitioner relied, but merely actions that allegedly had "the purpose and effect of furthering the fraudulent scheme." Pet. Br. 14; *see id.* at 12. The "schemers" that

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[2] In 2002, Congress again considered and rejected efforts to extend the private right of action to reach aiders and abettors. Senator Shelby proposed an amendment to the bill that became the Sarbanes-Oxley Act of 2002 that would have added a "private litigation" provision stating that "persons that aid or abet violations . . . shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." 148 Cong. Rec. S6584 (daily ed. July 10, 2002). No such provision appears in the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. *See also* H.R. Rep. No. 107-414, at 54 (2002) (minority views observing that the SEC and others had urged Congress to overturn *Central Bank*'s bar on private suits against aiders and abettors and lamenting that Congress did not "now heed these recommendations" and expand the private right of action).

petitioner's theory would reach include most if not all the aiders and abettors that Congress dealt with in a different manner, plus an unbounded set of other persons who dealt with the primary violator in any way that a plaintiff can allege furthered the fraudulent scheme.

To the extent that the "scheme liability" alleged in this case can be distinguished at all from the aiding and abetting liability rejected in *Central Bank*, it poses even more serious dangers of vexatious litigation. "Aiding and abetting" is at least a legal category with a long history and extensive statutory and common law definitions in various contexts. *See, e.g., Central Bank*, 511 U.S. at 180-183 (describing history of aiding and abetting liability). "Scheme liability" would, presumably, potentially reach anyone who dealt in any pertinent way with the person who is alleged to have engaged in the fraud, a much wider range of potential defendants. Since defendants are jointly and severally liable, *see* 15 U.S.C. § 78u-4(f)(2), the plaintiff can threaten any person with an assertable connection to the "scheme" with the massive damages often involved in securities fraud cases.

Moreover, the scope of "scheme liability," like the aiding and abetting liability at issue in *Central Bank*, is "unclear, in an area that demands certainty and predictability." *Central Bank*, 511 U.S. at 188 (internal quotation marks omitted). A "scheme liability" theory would be untethered to the accepted elements of § 10(b) actions—particularly reliance, loss causation, and materiality. The courts would need to develop a whole new body of law to determine how Rule 10b-5 will work with respect to individuals and entities, such as suppliers, lenders, and professional advisers, with even simple and peripheral relationships with the entity making the misstatements or omissions. In the meantime, market participants will have inadequate guidance regarding the legality of a variety of conduct. "[S]uch a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5 is not a satisfactory basis for a rule of liability imposed on the conduct of business transactions." *Id.* (internal quota-

tion marks omitted) (alterations in original). And this sort of amorphous liability threat and disproportionate exposure will not only aggravate the dangers of vexatious litigation but also cannot help but distort business relations.

The PSLRA's particular steps to deter vexatious private suits are also inconsistent with a private "scheme liability" theory. Key among the constraints placed on private suits were heightened pleading requirements in § 78u-4(b)(1) for claims involving "misleading statements and omissions." A complaint must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). A suit based on "scheme liability," however, would evade these requirements. The defendant may, as in this case, never have deceived anyone with whom it dealt, and never have made any statement or omission on which any relevant investor relied. Accordingly, these additional requirements—Congress's chosen protections against frivolous suits—would have no deterrent effect on such suits.[3] Permitting private suits based on "scheme liability" would circumvent protections against abuse established by the PSLRA while greatly expanding the scope of potential defendants.

E. The Statutory Limitations On The Express Causes Of Action In The Securities Laws Support A Narrow Reading Of The Implied Right Of Action Under § 10(b) That Does Not Extend To "Scheme Liability"

As part of its analysis of the scope of private rights of action under § 10(b), this Court has considered "the express causes of action in the securities Acts as the primary model

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[3] The pleading requirements of Fed. R. Civ. P. 9(b), including the requirement to plead fraud with particularity, would apply to "scheme" liability claims, but as the Conference Report on the PSLRA recognized, "[t]he Rule has not prevented abuse of the securities laws by private litigants." H.R. Conf. Rep. No. 104-369, at 41 (1995).

for the 10(b) action," on the theory that "[h]ad the 73rd Congress enacted a private § 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the Securities Acts." *Central Bank*, 511 U.S. at 178. Using that mode of analysis and recognizing the care with which Congress delineated the express causes of action, this Court has repeatedly refused to expand implied rights of action in a way that would effectively override the limits on the express remedies. *See, e.g., id.*; *Ernst & Ernst*, 425 U.S. at 200-201; *Lampf*, 501 U.S. at 359-360. After all, it would be "anomalous to impute to Congress an intention in effect to expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action." *Central Bank*, 511 U.S. at 180. An analysis of the express causes of action confirms that the private right of action under § 10(b) should not be extended to "scheme liability."

It is apparent from the careful crafting of the express causes of action that the 1933 and 1934 Congresses did not intend to give investors wide open private rights of action against indirect participants in an alleged fraud. The express causes of action each strictly cabins the scope of potential defendants or the unlawful conduct, and some of the express causes of action do both. For example, only persons who sign the registration statement, express an expert opinion on the statement, or served as a director of the issuer or underwriter in the offering may be liable under Section 11 of the 1933 Act. 15 U.S.C. § 77k. Likewise, Section 12(2) of the 1933 Act extends liability only to persons who utilize a false or misleading prospectus to "offer[] or sell[] a security." *Id.* § 77*l*. In *Pinter* v. *Dahl*, 486 U.S. 622 (1988), the Court found no textual basis or "congressional intent to incorporate tort law doctrines," *id.* at 652, and rejected arguments that parties should be liable "whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place," *id.* at 649 (footnote and citation omitted). The Court also refused to extend the reach of the statute to "persons who 'participate in soliciting the purchase.'" *Id.* at 651 n.27. Similarly, persons are liable under Section 18 of

the 1934 Act only if the plaintiff actually relied on the person's false statements in documents filed with the Commission. Significantly, Section 18 also reaches only persons "who shall make or cause to be made" a false or misleading statement in an SEC filing.

The petitioner in this case has requested an expansion of the § 10(b) implied right of action to a nebulous category of conduct and an undefined class of parties. Just as this Court rejected the invitation in *Pinter* to extend liability to a indirect participants, it should refuse to endorse petitioner's theory of "scheme liability," which would render liable actors only obliquely connected to allegedly fraudulent schemes. This Court should continue to take guidance from the approach that Congress chose of precisely delineating the scope of the express causes of action under the federal securities laws.

II. THE SEC LACKS AUTHORITY TO DETERMINE THAT THERE IS A PRIVATE RIGHT OF ACTION FOR "SCHEME LIABILITY"

The Petition for a Writ of Certiorari and Amici Former SEC Commissioners make much of the SEC's support, expressed in other courts, for a private right of action for "scheme liability," implying a major role for the SEC in assessing the scope of the § 10(b) private right of action. *See* Pet. 23-24; Br. of Former SEC Comm'rs 2, 6-7. Contrary to this suggestion, the SEC's views on private rights of action for "scheme liability" are due no deference from this Court.

First, the SEC's requests for judicial extension of the private right of action to "scheme liability" run contrary to Congress's judgments on the matter. In the legislation following *Central Bank*, Congress considered and rejected SEC proposals to extend private rights of action beyond claims of misstatements and omissions on which a plaintiff relied to actions that merely had the goal and effect of advancing the fraudulent scheme. Accordingly, the SEC's expressions of support for private "scheme liability" are contrary to a clear congressional determination. Second, regardless of the particulars of the SEC's views, the SEC is not entitled to deference on this question because Congress

has not delegated authority to the SEC to resolve questions concerning the existence or scope of private rights of action under § 10(b).

A. SEC Support For An Extension Of The § 10(b) Private Right Of Action Is Contrary To Congressional Intent

In amicus briefs filed in other courts, the SEC has supported the expansion of the § 10(b) private right of action to include "scheme liability." Br. of Amicus Curiae the Securities Exchange Commission 16, *Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006) (No. 04-55665) (SEC *Simpson* Amicus Br.); *see also* Reply Br. of Amicus Curiae the Securities Exchange Commission 5, *Simpson* v. *AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006) (No. 04-55665) (SEC *Simpson* Amicus Reply). The SEC opined that private liability should apply to "[a]ny person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud." SEC *Simpson* Amicus Br. 16. The Commission's proposed test transparently "include[d] conduct beyond the making of false statements or misleading omissions" and contemplated that "[t]he reliance element should be viewed as satisfied whenever a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction." *Id.* at 8. The Court need not defer to the SEC's views.

The familiar two-part test of *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), provides that a court must first ask whether "Congress has directly spoken to the precise question at issue" and, if not, whether the agency's view "is based on a permissible construction of the statute." *Id.* at 842-843. The SEC's views in *Simpson*, however, do not satisfy the first step of the *Chevron* analysis.

Under *Chevron* step one, Congress has "directly spoken to the question at issue." As the SEC itself and Congress both acknowledged, in enacting the PSLRA Congress re-

jected the SEC's efforts to extend private liability beyond those making misstatements and omissions on which a plaintiff relied to include aiders and abettors. *See supra* pp. 13-15. In the PSLRA and ensuing legislation, Congress has focused on limiting private suits not expanding them; the limits placed on private suits, moreover, operate on the assumption that such suits are limited to claims of misstatements or omissions on which the plaintiff relied. *See supra* p. 18.

When applying the first step of the *Chevron* analysis, this Court has looked to the "plain language of the statute," *HUD* v. *Rucker*, 535 U.S. 125, 130 (2002), and has also considered the broader context of Congress's legislation in the area, *see, e.g.*, *FDA* v. *Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160-161 (2000) (rejecting the FDA's view that it had the authority to regulate tobacco on the ground that it required a "strained" reading of the statute and would "ignore the plain implication of Congress's tobacco-specific legislation"). When the 1934 Act is coupled with Congress's more recent legislation, "the intent of Congress is clear"—to limit private rights of action to persons making the misstatements or omissions on which the plaintiff relied.

"Scheme liability," like aiding and abetting, does not involve misstatements or omissions on which the plaintiff relied. Rather, it concerns actions that had "the purpose and effect of furthering the fraudulent scheme." Pet. Br. 14; *id.* at 12. As noted above, the "schemers" would include most if not all the aiders and abettors that Congress has already determined should not be subject to § 10(b) private liability, plus a potentially limitless group of additional persons who acted with the primary violator in a way that a plaintiff might argue advanced the "scheme." Congress's rejection of the SEC's request to extend private liability to aiders and abettors must therefore foreclose any deference to the SEC's efforts to obtain in the courts even broader private

enforcement than the aiding and abetting cause of action that Congress would not provide.[4]

B. Principles Of Deference To Administrative Agencies Do Not Apply To The Question Whether To Extend The § 10(b) Private Right Of Action To "Scheme Liability"

The SEC's views on the question whether to extend the § 10(b) private right of action to "scheme liability" are not due any deference under traditional administrative law principles for an additional reason: *Chevron* provides deference to an agency's reasonable interpretation of a statute, but only where Congress has delegated authority to the agency to interpret the statute. "A precondition to deference under *Chevron* is a congressional delegation of administrative authority." *Adams Fruit Co.* v. *Barrett*, 494 U.S. 638, 649 (1990).

There is plainly no express delegation of authority to the SEC on the present issue. *See supra* pp. 5-8; *cf. Lampf*, 501 U.S. at 359 ("[W]e have made no pretense that it was Congress' design to provide the remedy afforded."). Nor can there be any implicit delegation of authority on this question. While administrative law recognizes that Congress can delegate authority to an agency implicitly as well as explic-

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[4] These arguments based on congressional intent should not be discounted as resting on congressional inaction. Congress did act upon the question of liability for aiding and abetting, giving the SEC enforcement authority but declining to give private litigants a complementary right of action. *Cf. Sandoval*, 532 U.S. at 290 ("The express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others."). Given *Central Bank* and the purposes of the PSLRA, moreover, Congress plainly did not decline to create private liability for aiding and abetting because it deemed such liability already fairly included in the statute. In any event, although this Court has cautioned against reliance on congressional inaction in discerning Congress's intent, it has nonetheless cited "legislative acquiescence" in cases concerning the private right of action under § 10(b). *See, e.g., Basic Inc.*, 485 U.S. at 230-231 (1988); *Central Bank*, 511 U.S. at 186-187.

itly,[5] this Court has made clear that it will not infer Congress's delegation of authority to an agency, such as the SEC, to create or extend a judicial cause of action not created or extended by the statute itself, at least where such delegation is not Congress's own discernible intent. *See, e.g.*, *Piper*, 430 U.S. at 41 n.27, 43 (1977) (explaining that "administrative deference" was inappropriate on the question of the availability of a private right of action under § 14(e) of the Securities Exchange Act because the SEC's "presumed 'expertise' in the securities-law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution"); *Adams Fruit*, 494 U.S. at 649-650 (rejecting *Chevron* deference to agency views on the availability of a private right of action under the Migrant and Seasonal Agricultural Worker Protection Act (AWPA), 29 U.S.C. §§ 1801 *et seq.*, on the ground that "[n]o such delegation regarding AWPA's enforcement provisions is evident in the statute").[6]

Even where the agency has been authorized to administer the statute, the Court will not infer a delegation of authority over questions regarding the existence of a private right of action. *See, e.g.*, *Adams Fruit*, 494 U.S. at 649 (observing that Congress "expressly mandated a role for the Department of Labor in administering the statute ... [but] [t]his delegation, ... does not empower the Secretary to regulate the scope of the judicial power.")[7]

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[5] *See, e.g.*, *United States* v. *Mead Corp.*, 533 U.S. 218, 229 (2001).

[6] *See also Sandoval*, 532 U.S. at 291 (rejecting agency efforts to create a private right of action under § 602 of the Civil Rights Act by regulation and noting that it "is most certainly incorrect to say that language in a regulation can conjure up a private cause of action that has not been authorized by Congress [because] [a]gencies may play the sorcerer's apprentice but not the sorcerer himself."); *Redington*, 442 at 577 n.18 ("SIPC and the Trustee also appear to suggest that the rules adopted under § 17(a) can themselves provide the source of an implied damages remedy even if § 17(a) itself cannot. It suffices to say, however, that the language of the statute and not the rules must control." (citations omitted)).

[7] Lower courts have followed the Supreme Court's lead and declined to defer to agency positions on questions regarding private rights of ac-

In resolving the various questions regarding private actions under § 10(b), this Court has consistently held that the judiciary has the responsibility for defining the contours of the right of action, *see, e.g.*, *Musick*, 508 U.S. at 292-293 ("[t]he federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes"), and demonstrated that it will not defer to the SEC on questions regarding private rights of action under § 10(b). In *Blue Chip Stamps*, 421 U.S. at 738, 743, 746 n.10, for example, the Court emphasized the "judicial role of interpreting" the implied private right of action under § 10(b), and held that the cause of action under § 10(b) was limited to "purchasers" or "sellers" of securities. In so holding, the Court acknowledged that "a great majority of the many commentators on the issue" including the SEC (in an amicus brief), supported a more expansive private liability scheme. The Court described the SEC's views but treated them no differently from the other commentators' opinions, not according the SEC's position any particular deference.

Likewise, in *Ernst & Ernst*, 425 U.S. at 193, 197-198, 207-208, the Court acknowledged the SEC's arguments in an amicus brief in support of permitting a private right of ac-

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tion or to permit agencies to manufacture causes of action. In *Murphy Exploration & Production Co.* v. *Department of Interior*, 252 F.3d 473 (D.C. Cir. 2001), the D.C. Circuit determined that "*Chevron* deference was inappropriate" on the question of what may trigger a statute of limitations on a judicial remedy provided by Congress. *Id.* at 478. The court explained that a "principal reason" for the lack of deference is that the statutory provisions establishing the remedy "do not grant powers to agencies": "Unless the agency is the recipient of congressionally delegated power, there is no reason to defer to its interpretations of the statute that does the delegating." *Id.* at 478-479. The court further remarked that "administrative agencies have no particular expertise" in questions of the scope of judicial authority over private claims. *Id.* at 479; *see also Iverson* v. *City of Boston*, 452 F.3d 94, 100 (1st Cir. 2006) (rejecting the suggestion that an agency regulation may give rise to a private right of action and observing that "the power to create a private cause of action, like the power to create a positive federal law itself, lies exclusively with Congress").

tion under § 10(b) "in the absence of any allegation of 'scienter,'" but rejected the arguments without any suggestion that it might defer to the SEC view. *See also Central Bank*, 511 U.S. at 188-191 (dismissing SEC arguments in support of an implied private right of action over aiding and abetting without discussion of any deference due); *Lampf*, 501 U.S. at 361 (rejecting SEC view regarding statute of limitations for private right of action).[8]

The Court has explicitly rejected deference to the SEC on questions concerning the existence of private rights of action under parallel provisions of the securities laws. In *Piper*, 430 U.S. at 43, the Court declined to create an implied right of action for tender offerors under § 14(e) of the Securities Exchange Act. In so doing, the Court rejected the SEC's support for this right of action, finding that the SEC's view was due no deference: "[T]he narrow legal issue is one peculiarly reserved for judicial resolution, namely whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants." *Id.* at 41 n.27; *see also id.* ("[I]n our prior cases relating to implied causes of action, the Court has understandably not invoked the 'administrative deference' rule, even when the SEC supported the result reached in the particular case."); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 23 (1979) (re-

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[8] This is not to suggest that the Court never affords the SEC's views deference on questions concerning § 10(b) or Rule 10b-5. For example, in *Basic Inc.*, 485 U.S. 224, the Court addressed the materiality requirement of Rule 10b-5. There, the Court explained the SEC's view and stated: "The SEC's insights are helpful, and we accord them due deference." *Id.* at 239 n.16. *Basic* did not address the proposition that the Court determines the existence of private rights of action. Section 10(b) makes certain acts unlawful only to the extent that they violate SEC rules and regulations. Giving "due deference" to "helpful" SEC views on questions of the meaning of certain terms in the Commission's own rules, as the Court did in *Basic*, is not the same as deferring on the question whether there is a private right of action available under the statute; as explained in *Sandoval*, the regulation itself cannot give rise to a cause of action not created by Congress.

jecting SEC views on whether a private right of action should be implied under the Investment Advisers Act).

CONCLUSION

For these reasons, the decision below should be affirmed.

Respectfully submitted.

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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I.

INTEREST OF AMICUS CURIAE[1]

The California State Teachers' Retirement System ("CalSTRS") is the second largest public pension fund in the United States. CalSTRS manages the retirement funds for California's public school teachers from kindergarten through community college. CalSTRS has a total membership of approximately 800,000, and assets of approximately $171.1 billion. The mission of CalSTRS is to secure the financial future and to sustain the trust of California's educators. As part of this mission, CalSTRS is committed to taking steps to enhance corporate governance and the integrity of the securities markets. The integrity of the securities markets is vital to CalSTRS' mission.

Income to CalSTRS comes from member contributions, school district contributions, investment earnings, and appropriations from the General Fund of the State of California. Like other public pension funds, CalSTRS is obligated to provide guaranteed benefits to its members. As a result, investment losses caused by securities fraud create burdens on all taxpayers.

CalSTRS is the lead plaintiff in the PSLRA class action *In re Homestore.com Securities Litig.*, C.D. Cal. case no. cv 01-11115 SVW. Homestore.com was a company that engaged

1. This brief was not authored, in whole or in part, by counsel for any party. No person or entity other than *amicus* and its counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of this brief and a copy of their consent has been lodged with the Clerk of the Court and is attached to this brief.

in fraudulent transactions with other companies, such as America Online and Cendant Corporation. All of the parties knew that the transactions were shams designed and executed with the primary purpose of enabling each of the companies to misrepresent their financial condition. The *Homestore.com* action gave rise to the decision of the United States Court of Appeals for the Ninth Circuit in *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006), in which the United States Court of Appeals for the Ninth Circuit enforced a standard consistent with the position of the Securities and Exchange Commission. This decision is presently the subject of a pending petition for certiorari filed by Cendant Corporation *sub nom Avis Budget Group, Inc. v. California State Teachers' Retirement System,* No. 06-560 (Oct. 19, 2006).

II.

SUMMARY OF ARGUMENT

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) and (c) prohibit knowing conduct that has the principal purpose and effect of creating a false appearance about a public corporation's business and financial results in furtherance of a scheme to defraud investors. The statute and rule have never been limited to those who affirmatively make statements or material omissions. The decision of the Eighth Circuit would place such a limitation on liability under the statute and rule, creating a safe harbor for those who would engage in fraud and impair the securities markets. No such requirement is present in the statute, no such requirement exists in the rule, and the consequences of such a rule would threaten the integrity of the securities markets.

Given the substantive requirements of the federal securities laws and the procedural reforms made to those laws through the enactment of the Private Securities Litigation Reform Act ("PSLRA") and the Securities Litigation Uniform Standards Act ("SLUSA"), judicial rewriting of the Securities Exchange Act and Rule 10b-5 is unnecessary and unwise. The PSLRA and SLUSA made wholesale changes in the manner in which securities claims are litigated and tried. Analysis of trends in securities litigation since the enactment of PSLRA and SLUSA demonstrates that the number of securities actions filed has declined while the recoveries to investors have increased. Institutional plaintiffs, acting in the role of lead counsel under the PSLRA as provided by Congress, have been instrumental in recovering billions of dollars for investors in federal securities actions. These include:

Enron, in which the Regents of the University of California as lead plaintiff secured over $8 billion in recovery for shareholders.

Worldcom, in which the New York State Common Retirement Fund secured over $6 billion in recovery for shareholders.

Tyco, in which the Louisiana State Employees' Retirement System and five other public pension funds secured over $3 billion in recovery for shareholders.

Cendant, in which the California Public Employees' Retirement System secured over $3 billion in recovery for shareholders.

AOL Time Warner, in which the Minnesota State Board of Investment secured over $2.5 billion in recovery for shareholders.

Nortel, in which the Ontario Teachers' Pension Plan Board and Treasury of the State of New Jersey secured over $1 billion in recovery for shareholders.

McKesson, in which the New York State Common Retirement Fund secured over $950 million in recovery for shareholders.

Adelphia, in which Eminence Capital LLC and five other institutional investors secured over $450 million in recovery for shareholders.

Healthsouth, in which the Retirement Systems of Alabama secured over $440 million in recovery for shareholders.

Global Crossing, in which the Ohio Public Employees' Retirement System and Ohio State Teachers' Retirement System secured over $445 million in recovery for shareholders.

Freddie Mac, in which the Ohio Public Employees' Retirement System and Ohio State Teachers' Retirement System secured over $400 million in recovery for shareholders.

These cases demonstrate that fraud and misconduct have occurred in the financial marketplaces and that the federal securities laws have enabled damaged investors to recover

at least some of their losses. In sum, these cases demonstrate that the system has been working.

The decision of the Eighth Circuit Court of Appeals would impair the integrity of the markets. It would provide an unwarranted and unnecessary immunity to liability under the federal securities laws. If upheld, the integrity of the financial markets will be placed in jeopardy to an extent not seen since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act and the Securities Exchange Act were enacted to remedy problems in the securities markets which led to the Great Depression. Among "Congress' objectives in passing the Act was to 'insure honest securities markets and thereby promote investor confidence' after the market crash of 1929." *S.E.C. v. Zandford*, 535 U.S. 813, 819 (2002) (quoting *United States v. O'Hagan*, 521 U.S. 642, 658 (1997)). These statutes have been integral parts of the unprecedented economic growth of the United States over the last seventy years.

The Court has recently noted that Section 10(b) and Rule 10b-5 play an "important part" in the "federal regulation of vital elements of our economy." *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71 (2006) ("[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated.").

The Eighth Circuit's decision is contrary to the basic purposes of the federal securities laws, contrary to the plain language of the federal securities laws, and contrary to the interpretation of the federal securities laws given by the Court and by the Securities and Exchange Commission. If the Eighth Circuit's analysis is upheld, a safe harbor for fraud

will be created which will lead to devastating consequences for the financial markets and for anyone who tries to plan for their retirement, including California's public school teachers. CalSTRS respectfully suggests that the decision of the Eighth Circuit should be reversed.

III.

ARGUMENT

A. THE PLAIN LANGUAGE OF THE STATUTE SHOULD GOVERN

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for "***any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of [Rule 10b-5].***" 15 U.S.C. § 78j(b).

The language of the statute governs the Court's interpretation. *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 173 (1994) (in determining the scope of conduct prohibited by § 10b "the text of the statute controls our decision[ ] . . . our cases considering the scope of conduct prohibited by 10(b) in private suits have emphasized adherence to the statutory language, '[t]he starting point in every case involving construction of a statute.'") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)).

In enacting the Securities Exchange Act, Congress predicated liability on the violation of "such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public

interest or for the protection of investors." 15 U.S.C. § 78j(b). In furtherance of this grant of authority, the Securities and Exchange Commission promulgated Rule 10b-5 which prohibits any person from "***directly or indirectly . . . employ[ing] any device, scheme, or artifice to defraud***" or "***engag[ing] in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security***." 17 C.F.R. § 240.10b-5(a) and (c). Rule 10b-5 is "coextensive with the coverage of § 10(b)." *S.E.C. v. Zandford*, 535 U.S. 813, 816 n.1 (2002); *see also United States v. O'Hagan*, 521 U.S. at 651; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 214.

Section 10(b) and Rule 10b-5(a) and (c) prohibit conduct beyond making false statements and misleading omissions. The Court has described as examples of prohibited conduct projects, schemes, stratagems, artifices, plans, practices, conduct, and acts. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 n. 20; *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-476 (1977); *United States v. O'Hagan*, 521 U.S. 642, 659 (1997).

Rule 10b-5(b) explicitly prohibits the making of an untrue statement or material omission while Rule 10b-5(a) and (c) apply to conduct other than making an untrue statement or material omission. "To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972). The Court noted that Section 10b-5's "proscriptions, by statute and rule, are broad and, by repeated

use of the word 'any', are obviously meant to be inclusive." *Id.* at 151.

The same analysis has been applied to Section 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)), which has analogous language to Rule 10b-5 and uses the disjunctive "or." In analyzing Section 17(a), the Court stated "each subsection proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities – not to narrow the reach of the prior sections." *United States v. Naftalin*, 441 U.S. 768, 774 (1979).

The breadth of the prohibition in Section 10(b) and Rule 10b-5 was noted in *Ernst & Ernst v. Hofchelder* where the Court stated that Section 10(b) was intended as a "'catchall'" provision to "'deal with new manipulative [or cunning] devices.'" 425 U.S. at 202 (quoting Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934)). The Court noted that Rule 10b-5 forbids "any course of conduct, that has the effect of defrauding investors." *Id.* at 212. The Court referenced Webster's International Dictionary (2d ed. 1934) for the definition of device as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive." *Id.* at 199 n.20.

The Court has previously addressed the scope of liability under the Securities Exchange Act and its analysis is not in accord with the Eighth Circuit's decision. In *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), the Court ruled that 10b-5 does not provide for liability for those who aid and abet violations of 10b-5, but went on to state that "any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material

misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191. (emphasis in original). *S.E.C. v. Zandford*, 535 U.S. 813, 821 (2002) confirms that liability can apply even in the absence of a material misstatement ("[i]ndeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' that conduct, without more, was a fraud.").

Neither the statute nor the rule provide that the only circumstances in which liability attaches are for misstatements or material omissions. Neither Congress nor the Securities and Exchange Commission have so limited liability. Judicially rewriting the statute and rule to include such a requirement would exempt from liability those who participate in fraudulent schemes. Rewriting the statute and rule would encourage deceptive conduct. Affirming the decision of the Eighth Circuit would frustrate the purpose and goals of Congress and the Securities and Exchange Commission in enacting Section 10(b) and promulgating Rule 10b-5.

Failing to give effect to the terms of Section 10(b) would contravene the basic rule of statutory construction that the Court is to give effect to each word of a statute if possible. *See Alaska Dep't of Envtl. Conservation v. E.P.A.*, 540 U.S. 461 (2004); *Duncan v. Walker*, 533 U.S. 167 (2001). The Eighth Circuit's analysis, which was based on policy considerations extrinsic to the statute, is flawed. "Policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would

lead to a result 'so bizarre' that Congress could not have intended it." *Central Bank*, 511 U.S. at 188.

B. THE COURT HAS RECOGNIZED THAT SECTION 10(b) AND RULE 10b-5 MUST BE CONSTRUED BROADLY TO ACCOMPLISH THEIR GOALS

The Court recognized the broad remedial goals of Section 10(b) and Rule 10b-5 in *Superintendent of Ins. of New York v. Bankers Life*, 404 U.S. 6, 11 n.7 (1971):

> [We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that §10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden variety type of fraud or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws. (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (1967).)

C. THE COURT HAS CONSISTENTLY CONSTRUED SECTION 10(b) AND RULE 10b-5 AS APPLYING TO CONDUCT BEYOND THE LIMITATIONS APPLIED BY THE EIGHTH CIRCUIT

In the more than seventy years since the Securities Exchange Act was enacted, the Court has never limited Section 10(b) and Rule 10b-5 in the way that the Eighth Circuit has done here. Rather, the Court has consistently

recognized the broad remedial purpose of Section 10(b) and Rule 10b-5 and applied the statute and rule to various types of conduct.

In *Superintendent of Ins. of New York v. Bankers Life*, 404 U.S. 6 (1971) the Court noted that "§ 10(b) bans the use of any deceptive device in the 'sale' of any security by 'any person'" and thus permitted claims to go forward against both an insider who sold bonds as well as "outside collaborators" who created the paperwork that allowed the insider to misappropriate the proceeds. 404 U.S. at 10.

In *Affiliated Ute*, the Court noted that although Rule 10b-5(b) applies to the making of an untrue statement of a material fact or the omission to state a material fact, "the first and third subparagraphs" – *i.e.*, Rule 10b-5(a) and (c) – "are not so restricted." 406 U.S. at 153; *see also Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977) (referencing prohibited conduct as "deception, misrepresentation, or nondisclosure.").

In *Herman & Maclean v. Huddleston*, 459 U.S. 375 (1983), the Court ruled that primary liability applies to those who cause misrepresentations to be made to investors as well as those who actually make misrepresentations. Discussing primary liability under Section 10(b) and Rule 10b-5, the Court said that Section 10(b) "extends to 'any person' who engages in fraud in connection with the purchase and sale of securities" even if the statements ultimately conveyed to shareholders are not attributed to that person. 459 U.S. at 379 n. 5.

In *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001) a unanimous Court held that

Section 10(b) and Rule 10b-5 liability is not confined to those responsible for misstatements or omissions.

> To succeed in a Rule 10b-5 suit, a private plaintiff must show that the defendant used, in connection with the purchase or sale of a security, one of the four kinds of manipulative or deceptive devices to which the Rule refers, and must also satisfy certain other requirements not at issue here.

532 U.S. at 593.

S.E.C. v. Zandford also makes plain that Section 10(b) and Rule 10b-5 liability may be violated by conduct alone, without any misstatement or omission by the defendant. 535 U.S. at 821 ("each time respondent 'exercised his power of disposition for his own benefit,' that conduct, 'without more,' was a fraud.") (quoting *United States v. Dunn*, 268 U.S. 121, 131 (1925)).

The Eighth Circuit's circumscription of Section 10(b) and Rule 10b-5 is contrary to the language of the statute and rule and contrary to the Court's decisions.

D. THE EIGHTH CIRCUIT'S INTERPRETATION IS CONTRARY TO THAT OF THE SECURITIES AND EXCHANGE COMMISSION

In the *In re Homestore.com Securities Litigation*, the Securities and Exchange Commission filed briefs as *Amicus Curiae* in support of the position of CalSTRS concerning the scope of liability under Rule 10b-5(a) and (c). This brief is available at www.sec.gov/litigation/briefs/homestore_102104.pdf. In its brief, the Securities and

Exchange Commission set forth a standard which is consistent with Rule 10b-5(a) and (c) and contrary to the decision of the Eighth Circuit here. Under the Securities and Exchange Commission's proposed rule, primary liability is described as follows:

> Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10b-5 and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

Simpson v. Homestore.com, Inc., No. 04-55665, Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions that Favor Appellant, at * 16.

E. CONGRESS HAS NOT SOUGHT TO CHANGE THE PLAIN LANGUAGE OF THE STATUTE

Congress has not placed any limitation on the scope of liability under Section 10(b) and Rule 10b-5, but instead has confirmed that the statute and rule apply to conduct beyond misrepresentations and material omissions. When the PSLRA was enacted in 1995, Congress provided two separate tests to define a "knowing violation" – one for misrepresentations and the other for conduct. 15 U.S.C. § 78u-4(f)(1). In SLUSA, Congress referred to misrepresentations and omissions in the disjunctive from other deceptive conduct, indicating that each term had separate meaning. 15 U.S.C. § 78bb(f)(5)(E). If Congress had intended Section 10(b) and Rule 10b-5 to apply only to misrepresentations and omissions, then it was wasting its time in drafting the language in the PSLRA and SLUSA

cited above. Commentators have noted that these provisions demonstrate that Congress "clearly anticipated the continued liability of secondary defendants." J. Fisch, *In Search of Liability Standards for Secondary Defendants*, 99 Col. L. Rev. 1293, 1313 (1999). These provisions would be "of limited importance unless the general standard of liability holds collateral defendants responsible" for their own fraudulent conduct. *Id.*

F. THE EIGHTH CIRCUIT'S ANALYSIS WILL DAMAGE THE INTEGRITY OF THE MARKETPLACE

If the Eighth Circuit's decision is upheld, there will be serious negative consequences for the financial markets and investors. Investor confidence would be undermined, which would itself lead to a downturn in and flight from the capital markets. Congress expressly recognized the importance of private securities litigation – which it deemed an "indispensable tool" – in helping to "promote public and global confidence in our capital markets" by helping to deter wrongdoing. Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995). The Court has stated that private securities actions "provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)); *see also Lampf v. Gilbertson*, 501 U.S. 350, 374 (1991) (Kennedy, J., dissenting ("private § 10(b) suits constitute 'an essential tool for enforcement of the 1934 Act's requirements'") (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988)).

G. UPHOLDING THE PLAIN LANGUAGE OF SECTION 10(b) AND RULE 10b-5 WILL NOT IMPAIR LEGITIMATE BUSINESS

In reaching a conclusion contrary to the plain language of Section 10(b) and Rule 10b-5, the Eighth Circuit adverted to the potential consequences to the business community. These concerns are legitimate but do not support the Eighth Circuit's decision. The interpretation of Section 10(b) and Rule 10b-5 by the Court and the lower courts, as well as the amendments to the federal securities laws through the PSLRA and SLUSA, insure that legitimate business conduct will not become subject to liability. Only conduct undertaken with the intent to defraud and as part of a scheme will give rise to liability. No business will suffer undue expense or burden because of the heightened pleading standards of the PSLRA which require that a plaintiff plead specific facts giving rise to a strong inference of scienter before an action may go forward. 15 U.S.C. § 78u-4(b)(2).

IV.

CONCLUSION

It is respectfully submitted that the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICUS CURIAE*[1]

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. The Chamber's underlying membership includes more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files *amicus curiae* briefs in cases that raise issues of concern to the nation's business community, such as cases involving the federal securities laws, including *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), and *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336 (2005).

"Scheme" liability is nothing but a label in search of a cause of action. In reality, it is aiding and abetting liability disguised behind a new name. The Chamber has a vital interest in the "scheme" liability theory. The "scheme" liability label, which emerged after this Court and Congress rejected aiding and abetting liability in private § 10(b) actions, has been extended to commercial counterparties involved with an issuer merely through a commercial or financial transaction. It has no effective limiting principle, which is reason enough to reject the theory. *Santa Fe Indus.*,

---

[1] Pursuant to this Court's Rule 37.6, *amicus curiae* states that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amicus curiae* made a monetary contribution to the preparation or submission of the brief.

Pursuant to Rule 37.3, *amicus curiae* states that petitioner and respondents have consented to the filing of this brief. Petitioner has filed with the Clerk of the Court a letter granting blanket consent to the filing of amicus briefs, and a letter reflecting the consent of respondents to the filing of this brief has been filed with the Clerk.

Inc. v. *Green*, 430 U.S. 462, 478 (1977) (rejecting § 10(b) claims that "could not be easily contained").

"Scheme" liability would put American companies, including the Chamber's members, at two tremendous competitive disadvantages. First, American issuers of securities would have to price their commercial transactions to reflect the substantial added risk of liability for their counterparties. Second, and even more important, to avoid litigation risk, both domestic and foreign companies would have significant incentives to do business with companies listed on foreign exchanges, or with private companies. The Chamber's members would prefer that business choices be based on factors like price, efficiency, quality, and service, rather than litigation risk.

INTRODUCTION AND SUMMARY OF ARGUMENT

Although expanding the implied § 10(b) action to cover "scheme" liability suffers from an aggregation of flaws, this brief focuses on two points of particular concern to the business community. First, the standard of liability under § 10(b) should be workable, predictable, and consistently applied so that businesses can plan their affairs with reasonable certainty. "Scheme" liability is wholly unworkable in implied § 10(b) actions. Accordingly, the Chamber submits that the proper standard is as follows: a commercial counterparty is liable under § 10(b) for deceptive "conduct" only when it has a duty to disclose to the issuer's shareholders. This standard follows this Court's precedent and is based on well-understood, time-honored concepts that lower courts can readily apply in a predictable manner.

Second, in order to provide much-needed guidance to lower courts and the business community, the Court should not merely decide the narrow question of the proper definition of the term "deceptive," but instead should recognize that the "scheme" liability theory would fundamentally alter many traditional elements of the implied cause of action in ways

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that contradict both the statute and this Court's precedent. Implied causes of action should not be interpreted in ways that contradict or nullify legislative decisions. The expansion of the § 10(b) implied cause of action through "scheme" liability would both override limits on the express causes of action that Congress created and nullify Congress's repeated decisions that only the SEC can sue for the conduct covered by "scheme" liability.

Moreover, "scheme" liability contradicts *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), on reliance and contradicts the Private Securities Litigation Reform Act of 1995 ("PSLRA") on loss causation. These doctrines are essential means of providing reasonable limitations on liability and the Court should make clear that the "scheme" liability theory is simply untenable because it eviscerates such limitations.

ARGUMENT

I. "SCHEME" LIABILITY IS IMPROPERLY DERIVATIVE AND UNWORKABLE.

The question before this Court is whether to recognize "scheme" liability as a legitimate implied private cause of action under § 10(b). The question presented in the *amici* brief of 32 state attorneys general offers a representative definition of "scheme" liability as a theory, *i.e.*,

> *shareholders can recover damages* from actors who, acting with the requisite intent to deceive, actively engage in conduct that has the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud the securities market, *even when the actor has made no false statement or omission and otherwise owes no fiduciary duty to the shareholders.*

Brief of Ohio, et al. ("Ohio Br."), at iii (emphasis added).

Petitioner, its amici, and lower courts have proposed an array of "scheme" liability standards, all of which share three common threads: the use of verbs that are synonymous with aiding and abetting or conspiracy; the intervening steps between the defendant's conduct and the issuer's statements that harmed the plaintiff; and the complete absence of a workable limiting principle. By contrast, the test this Court has repeatedly announced for § 10(b) liability for conduct—the existence of a duty to disclose by the specific defendant—has well-established contours and a fixed relationship to the existing elements of the private right of action.

A. Like Aiding-And-Abetting, "Scheme" Liability Is Derivative Of The Issuer's Conduct.

Petitioner asks this Court to find liability where defendants

> engaged in their own deceptive conduct in transactions with a public corporation *for the purpose and effect* of *creating* a false appearance of material fact that *enabled* the publication of artificially inflated *financial statements by the public corporation.*

Pet. Br. at *i* (emphases added). "Scheme" liability for a non-speaking defendant, like aiding-and-abetting, is purely derivative from the issuer's statements. Consider the words used by petitioner and *amici* to describe the conduct giving rise to "scheme" liability: "causing false financial statements to be published," *id.* at 22; *see also id.* at 30; Ark. Br. at 13, 14, "furthering the fraudulent scheme," Pet. Br. at 14, "participation" in a "scheme," *id.* at 14, 15, and "conspir[ing]" or "inducing" wrongdoing by the issuer, Prof. Adams Br. at 11, 17. These are simply ways of saying "aiding and abetting" or "conspiring" without using those words. *See Central Bank*, 511 U.S. at 181, 184 ("substantial assistance" or "knowing participation"); 15 U.S.C. § 78t(e). *See also Salinas* v. *United States*, 522 U.S. 52, 65 (1997) (conspiracy requires "adopt[ing] the goal of furthering or facilitating the criminal endeavor"). "Allegations of

'assisting,' 'participating in,' 'complicity in' and similar synonyms . . . all fall within the prohibitive bar of *Central Bank*." *Shapiro* v. *Cantor*, 123 F.3d 717, 720 (2d Cir. 1997). If anything, "scheme" liability is more expansive than aiding and abetting. Mere "participation" in a scheme that has some "effect" is easier to plead and prove than "substantial assistance."

Petitioner and its *amici* effectively admit the derivative essence of "scheme" liability. They admit that reliance and causation are satisfied in "scheme" cases not by reference to the conduct of a commercial counterparty such as respondents—whose conduct was unknown to the market—but rather because the issuer's "financial statements caused the price of [its] stock to be inflated and the purchasers of the stock were accordingly damaged." Pet. Br. at 38. *See also* Regents Br. at 16 (seeking damages for "falsifying the financial statements of a public company"). Decisions adopting "scheme" liability also have necessarily premised reliance and causation on the statements of the issuer rather than the unreported conduct of the counterparty. *See, e.g.*, *Simpson* v. *AOL TimeWarner Inc.*, 452 F.3d 1040, 1050-52 (9th Cir. 2006) ("the scheme [to defraud would not] be complete until the misleading information is disseminated into the securities market"), *petition for cert. filed*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 509-10 (S.D.N.Y. 2005) (purpose and effect of scheme was "to allow Parmalat to make such misrepresentations").

The very "purpose and effect" test is derivative. To avoid liability for acting recklessly, the counterparty is expected to investigate the "purpose" and accounting policies of the issuer. Moreover, the "effect" also depends on further action by an issuer: if the issuer has a change of heart and accounts correctly for the transaction, the conduct and intent of the commercial counterparty are precisely the same—but there would be no improper effect and thus no "scheme" liability.

B. Scheme Liability Is Unworkable And Uncertain.

Central Bank held that liability under § 10(b) is "'an area that demands certainty and predictability.'" 511 U.S. at 188 (quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988)). "Scheme" liability, however, would create a vague and unprincipled standard of private civil liability easily manipulated by plaintiffs' counsel with the benefit of hindsight. Every case of "scheme" liability would turn on post-hoc allegations of scienter, here called "purpose." As *Central Bank* held, the uncertainty created when a claim can be based entirely on alleged scienter drives up the costs of numerous legitimate transactions, and eliminates some altogether. *See* 511 U.S. at 188-89. Courts that have embraced "scheme" liability have inevitably allowed claims based on transactions that may well be legitimate. *See, e.g.*, *Parmalat*, 376 F. Supp. 2d at 504 n.160 (deceptive act allegation sustained even though bank merely may have accepted "valid receivables"); *In re Parmalat Secs. Litig.*, 414 F. Supp. 2d 428, 435 n.31 (S.D.N.Y. 2006) (deceptive act allegation sustained even though bank legitimately may have been exposed to "significant risk"). "Scheme" liability thus fosters judicial "decisions 'made on an ad hoc basis, offering little predictive value.'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652).

The goals of the securities laws are ill served when large settlements are paid because of uncertainty. Rather, businesses need clear and understandable rules to follow. *See Pinter*, 486 U.S. at 654 n.29 (rejecting liability for "those who are only tangentially involved with" a securities transaction, because if "the test produces unpredictable results, it risks over-deterring" lawful activities). "Scheme" liability is the antithesis of certainty. Among other things, a counterparty has no ability to audit or dictate accounting decisions made by the issuer's management and auditors. Moreover, business transactions are often subject to complex, changing, or

inherently subjective accounting rules.[2] In hindsight, it is easy to use labels such as "round-tripping" to suggest that a transaction had no proper purpose, even though "[t]he mere existence of reciprocal dealing does not suggest 'round-tripping.' Indeed, it is a common, legitimate, and perhaps useful business practice . . . ." *Teachers Ret. Sys.* v. *Hunter*, 477 F.3d 162, 178 (4th Cir. 2007). *See also Tellabs*, 127 S. Ct. at 2511 (noting distinction between legitimate and illegitimate forms of "channel stuffing").[3]

Unlike a company's own securities disclosures, even large commercial transactions may often be negotiated by personnel who are not versed in accounting principles. *See Nordstrom, Inc.* v. *Chubb & Son, Inc.*, 54 F.3d 1424, 1435-36 (9th Cir. 1995) (distinguishing between "directors and officers, who – unlike the public relations or personnel departments – are necessarily aware of the requirements of SEC regulations and state law and the 'danger[s] of misleading buyers and sellers'"). Requiring a business to monitor its counterparty's accounting in every commercial transaction will greatly expand costs and litigation risk. "'The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.'" *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 748 (1975) (quoting *Ultramares Corp.* v. *Touche*, 174 N.E. 441, 444 (N.Y. 1931) (Cardozo, J.)).

As Treasury Secretary Paulson testified, private civil "scheme" liability "would create a very uncertain legal environment for all the individuals and all the public

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[2] "GAAP is not a set of rigid rules ensuring identical treatment of identical transactions, but rather characterizes the range of reasonable alternatives that management can use." *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1421 n.10 (3d Cir. 1997) (Alito, J.).

[3] Similarly, "certain contracts may be legitimately backdated." *SEC* v. *Solucorp Indus., Ltd.*, 197 F. Supp. 2d 4, 11 (S.D.N.Y. 2002).

companies that deal with public companies" and would be "ultimately harmful to our economy." *The State of the International Financial Services System: Hearing Before the H. Fin. Servs. Comm.*, 110th Cong. (2007), *reprinted by* Fed. News Serv. *See also* Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, *Report and Recommendations* 90-91 (Mar. 2007) ("*Final Report*") (opposing "scheme" liability).[4] In particular, foreign companies would have a strong reason not to do business with American public companies. As *The Economist* stated: "An unfavorable ruling [in *Stoneridge*] would send a chill through boardrooms, and not only in America . . . [because] it would no longer even be necessary to issue shares in the United States to incur securities liability . . . . Any firm, anywhere, doing business with American companies would have to live with the risk that the transaction could later be portrayed as fraudulent or deceptive. And painting such pictures is what trial lawyers do best." *The Stoneridge Showdown*, Economist, Jun. 14, 2007, at 84.[5]

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[4] Indeed, two current SEC Commissioners have opposed "scheme" liability in public testimony because it has proved unworkable, creates "a real danger in chilling ongoing transactions," and will harm the "competitiveness of our economy." *A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007), *reprinted by* Fed. News Serv. (Statements of Paul S. Atkins and Kathleen L. Casey, Commissioners of the Securities Exchange Commission).

[5] *See also* Professor Rüdiger von Rosen, *Transatlantic Relations in Danger*, Boersenzeitung, June 28, 2007, at 14 (The President of the Deutsches Aktieninstitut, a business organization of German companies, explaining that "legal certainty and forseeability in transatlantic business could suffer a severe setback if [Petitioners are] successful," and could lead to a "wave of lawsuits" and "incalculable risks of class actions in the United States" that would require German companies doing business with listed companies in the U.S. "to examine the possibility of a false booking in every transaction, which is practically impossible." This could result in "transatlantic business relations [being] burdened by significant additional

C. Deceptive Conduct By A Commercial Counterparty Requires A Duty To Disclose.

As we have shown, "scheme" liability attempts to hold one defendant that did not speak to investors, often a commercial counterparty, liable for the issuer's misstatement. *Supra*, at 4-5. A well-developed body of law already exists, however, under which a defendant who engages in conduct, but neither makes a false or misleading statement to the market nor engages in market manipulation, can be sued for conduct "*only* where [a] duty to disclose arises from [a] specific relationship between two parties." *Central Bank*, 511 U.S. at

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costs from misunderstood investor protection."); Astrid Maier, *German Companies Threatened By New Risks in the United States*, Fin. Times Deutchland, June 8, 2007, at 10m ("there will be a whole new door opened for damages actions" that "'would mean that each and every engagement must be thoroughly examined' . . . In particular small and medium sized companies would be burdened with significant legal costs"); *Interim Report of the Committee on Capital Markets Regulation* 11, 71 (Nov. 30, 2006) ("*Interim Report*") ("Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market."); Michael Bloomberg & Charles Schumer, *Sustaining New York's and the US' Global Financial Services Leadership* ii (Jan. 2007) ("the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation" while "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors"); Jonathan Macey, *What Sarbox Wrought*, Wall St. J., Apr. 7, 2007, at A9 ("All of a sudden it is no longer fashionable to be a U.S. public company: It's for suckers who can't access the piles of sophisticated 'global' capital available elsewhere. . . . If the U.S. is to regain its former position in the world capital market, much more will have to be done. Massive litigation risk remains . . . .") Ian Swanson, *Foreign Executives Press For Reform Of Litigation in United States*, The Hill, May 17, 2007, at 11; ("litigation is a greater disincentive to doing business in the U.S. than fears that a protectionist Congress might impose new barriers to foreign trade and investment"); Alan Beattie, *London Named Top Financial Centre*, Fin. Times, June 12, 2007, at 6 (the United States has been disadvantaged because of its "litigious and apparently arbitrary culture of regulation and policy").

180 (emphasis added) (citing *Chiarella* v. *United States*, 445 U.S. 222, 228 (1980)). *See Chiarella*, 445 U.S. at 230 (liability for nondisclosure "is premised upon *a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction.*") (emphasis added); *id.* at 233 ("Formulation of such a broad duty, which *departs radically from the established doctrine that duty arises from a specific relationship between two parties*, should not be undertaken absent some explicit evidence of congressional intent") (emphasis added).

Unlike "scheme" liability, a duty to disclose is individual, not derivative, and provides an objective, workable, bright-line standard that looks at the relationship between the parties rather than the defendant's subjective intent. *See, e.g., id.* at 232-33 ("No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger . . . [to] the sellers."). Duty to disclose is a legal question, and there is well-developed law to guide businesses concerning when such a duty exists. *Id.* at 227 (duty to disclose standard "is not a novel twist of the law").

Petitioner and its *amici* incorrectly argue that there is no requirement of a duty to disclose when a non-speaking defendant engages in affirmative "conduct." Pet. Br. at 28; Brief of Change to Win & the CtW Inv. Group ("CTW Br."), at 16, 18-23; Brief of N. Am. Sec. Adm'rs Ass'n, Inc. ("NASAA Br."), at 13-17 & n.2. This argument has already been rejected by *Central Bank* and this Court's insider trading cases. In *Central Bank*, the Tenth Circuit had held that "the lack of a duty to disclose is not dispositive in this case." *First Interstate Bank of Denver, N.A.* v. *Pring*, 969 F.2d 891, 901 (10th Cir. 1992). The plaintiffs in *Central Bank* argued to this Court that the defendant could be liable without "a

preexisting duty to the victims of the fraud" because of "its participation in a concealed side agreement with the developer" to use an outdated appraisal in bringing a new bond offering to market. Brief for Respondents, No. 92-854, *available at* 1993 WL 407323, at *1-2, 7-8. Likewise, the SEC, as *amicus* in support of the *Central Bank* plaintiffs, said that the defendant engaged in "affirmative action, not merely silence or inaction." Brief for the United States as *Amicus Curiae*, No. 92-854 *available at* 1992 WL 12006433, at *5. This Court reversed, holding that "[a]s in earlier cases considering *conduct prohibited by § 10(b)*, we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Central Bank*, 511 U.S. at 177 (emphasis added).

Likewise in *O'Hagan*, this Court made clear that *conduct* by a defendant who did not speak to the market—trading on inside information—was "deceptive" under § 10(b) only when that defendant breached a duty to disclose. *See United States* v. *O'Hagan*, 521 U.S. 642, 660 (1997) ("[I]t was O'Hagan's failure to disclose his personal trading to [his client and law firm], *in breach of his duty to do so*, that made his *conduct* 'deceptive' within the meaning of § 10(b).") (emphasis added; alterations in original omitted).[6]

Petitioner incorrectly argues that a duty to disclose requirement would exclude "conduct" from § 10(b) and

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[6] This Court also has held that common law concealment and suppression require a duty to disclose. *Strong* v. *Repide*, 213 U.S. 419, 430 (1909) ("concealment is equivalent to misrepresentation" by insider purchasing stock from minority shareholder where "it was the *duty* of the party who obtained the consent, acting in good faith, *to have disclosed* the facts which he concealed") (emphasis added), *cited in Chiarella*, 445 U.S. at 228 n.10; *Stewart* v. *Wyoming Cattle-Ranche Co.*, 128 U.S. 383, 388 (1888) ("if, with intent to deceive, either party to a contract of sale conceals or suppresses a material fact which he is in good faith *bound to disclose*, this is evidence of and equivalent to a false representation") (emphasis added).

render subsections (a) and (c) of Rule 10b-5 a nullity. *See, e.g.*, Pet. Br. at 24. Liability when a silent defendant breaches a duty to disclose does not arise under Rule 10b-5(b) because that subpart addresses only speaking defendants. Specifically, Rule 10b-5(b) applies only when a defendant "make[s] any untrue *statement* of material fact" and "omit[s] to state a material fact necessary in order to make *the statements made*, in light of the circumstances under which they were made, not misleading," *i.e.*, half-truths. (Emphasis added.) In contrast, Rule 10b-5(a) and (c) apply to at least four kinds of actionable conduct by non-speaking defendants—demonstrative conduct (*e.g.*, nodding assent at a press conference), omitting to disclose conduct by a party with a duty to disclose, insider trading, and market manipulation. Indeed, this Court's cases dealing with breach of a duty to disclose and insider trading have frequently arisen under Rule 10b-5(a) and (c). *See, e.g., O'Hagan*, 521 U.S. at 651; *SEC* v. *Zandford*, 535 U.S. 813, 819 (2002); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 152-53 (1972).

Section 10(b) does not proscribe deceptive conduct in the abstract, however. To "use or employ" a deceptive device within the meaning of § 10(b), a defendant must actually mislead someone. *See O'Hagan*, 521 U.S. at 655, 659 n.9, 660. In a private civil case, that someone must be the plaintiff. Private civil liability statutes, including the implied cause of action under § 10(b), incorporate the general principle that a plaintiff must show not merely a violation of law, but breach of a legal duty owed *to that specific plaintiff*. *See, e.g., Bangor Punta Operations, Inc.* v. *Bangor & Aroostook R.R.*, 417 U.S. 703, 716 n.13 (1974) ("the recovery provided is intended to compensate, not the public generally, but those who have been injured by a breach of *duty owed to them*") (emphasis added); *Foss* v. *Bear, Stearns & Co.*, 394 F.3d 540, 541 (7th Cir. 2005) (Easterbrook, J.) (§ 10(b) private civil claim requires deceit against the plaintiff); *Moss* v. *Morgan Stanley, Inc.*, 719 F.2d 5, 13, 16 (2d Cir. 1983)

(although investment bank employee was criminally convicted for § 10(b) insider trading because of breach of duty to his employer and its client, a tender offeror, shareholders in target company had no § 10(b) claim because "'[t]here is no "duty in the air" to which any plaintiff can attach his claim.'") (citation omitted); *see also Cipollone* v. *Liggett Group, Inc.*, 505 U.S. 504, 522 (1992) (plurality opinion) (citing *Black's Law Dictionary* 1489 (6th ed. 1990) as "defining 'tort' as 'always [involving] a violation of some duty, *owing to plaintiff*'") (emphasis added; alteration in original).

Commercial counterparties do not have or breach any duty to the issuer's investors. Any deception used or employed against those shareholders comes from the accounting of the issuer (which has a duty to disclose), not from the transaction of the counterparty (which does not). If Charter's accounting had expensed rather than capitalized the increase in the prices for set-top boxes, there would be no alleged deception. A commercial counterparty has no relationship with the issuer's investors and thus no duty to disclose. In those circumstances, there is no implied private civil liability under § 10(b).

II. THE IMPLIED CAUSE OF ACTION UNDER § 10(b) SHOULD NOT BE EXTENDED TO ENCOMPASS "SCHEME" LIABILITY.

The Petitioner's question presented broadly asks whether *Central Bank* "forecloses claims under § 10(b)" and merely assumes that "Respondents engaged in their own deceptive conduct." Pet. Br. at *i*. Indeed, Petitioner expressly asks the Court to decide whether "scheme" liability satisfies the elements of reliance and causation necessary for private civil claims under § 10(b). *Id.* at 37-40. The Court should address the broader question of whether "scheme" liability is a basis for primary liability under the § 10(b) implied cause of action, and not only whether a commercial counterparty's participation in a commercial transaction could constitute

"deceptive" conduct in the abstract. Rejection of the broader argument is vital to the competitiveness of American businesses. *See supra*, at 6-8. *Central Bank* itself addressed reliance, which is an element of only the implied cause of action. *See* 511 U.S. at 180.[7]

Of course, if the statutory language precludes "scheme" liability, that is the end of the matter. But when the statutory language is not dispositive, the Court should limit the implied § 10(b) action to ensure that this "judicial oak" does not grow even further afield from the "legislative acorn." *Blue Chip*, 421 U.S. at 737; *see also Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1102 (1991) ("the breadth of the [implied private] right once recognized should not, as a general matter, grow beyond the scope congressionally intended").[8] As *Blue Chip* held: "We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited . . . ." 421 U.S. at 749. Thus, even assuming that the SEC or Justice Department could bring a claim that a "sham" transaction by a commercial counterparty was a "deceptive" act, § 10(b) has no language suggesting that private plaintiffs could sue that commercial counterparty. *Id.* ("No language in either of [§ 10(b) or Rule 10b-5] speaks at all to the contours of a private cause of action . . . ."); *see Lampf, Pleva, Lipkin, Prupis & Pettigrow* v. *Gilbertson*, 501 U.S. 350, 359 (1991) ("We have made no pretense that it was Congress's design to provide the remedy afforded.").

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[7] The reliance holding in *Central Bank* reflects "a longstanding limitation on private § 10(b) suits" that does not apply to "criminal liability." *O'Hagan*, 521 U.S. at 664. Similarly, reliance need not be proven in SEC administrative actions under § 10(b). *See, e.g., SEC* v. *Credit Bancorp, Ltd.*, 195 F. Supp. 2d 475, 490-91 (S.D.N.Y. 2002).

[8] *Cf.* 501 U.S. at 1110 (Scalia, J., concurring) (when "the federal cause of action at issue here was never enacted by Congress . . . the more narrow we make it (within the bounds of rationality) the more faithful we are to our task") (citation omitted).

Moreover, this Court's approach is "to construe statutes, not isolated provisions." *Gustafson* v. *Alloyd Co.*, 513 U.S. 561, 568 (1995). In particular, the Court has cabined the implied § 10(b) cause of action so that it does not render superfluous the restrictions in other provisions of the 1933 and 1934 Acts. *See, e.g., Central Bank*, 511 U.S. at 178-79 ("we use the express causes of action in the Securities Acts as the primary model for the § 10(b) action"); *id.* at 182-83; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 206-10 (1976); *Blue Chip*, 421 U.S. at 736. Examination of the provisions of the 1933 and 1934 Acts shows that the § 10(b) implied action should not be extended to create private civil claims for "scheme" liability. First, it would improperly override the limits on the express civil claims created by Congress. Second, it would undo Congressional decisions that only the SEC and the Justice Department may sue defendants for participating in a scheme. "The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere." *Central Bank*, 511 U.S. at 184. Third, "scheme" liability does not satisfy the established reliance and loss causation elements necessary for primary liability in a § 10(b) private cause of action.

A. "Scheme" Liability Would Nullify Statutory Restrictions On The Express Private Rights Of Action In The 1933 And 1934 Acts.

One statutory provision should not be interpreted to render another provision a "practical nullity." *United Sav. Ass'n* v. *Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 375 (1988). Thus, this Court will not "expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action." *Central Bank*, 511 U.S. at 180; *see also Virginia Bankshares*, 501 U.S. at 1104 ("we would have trouble inferring any congressional urgency to depend on implied private actions to deter violations of § 14(a), when Congress expressly provided private rights of action in

§§ 9(e), 16(b), and 18(a) of the same Act"). Private civil "scheme" liability under § 10(b) violates this principle.

1. § 18(a): Congress addressed in § 18(a) of the 1934 Act, not § 10(b), when a silent defendant should face private civil liability based on another defendant's misstatement or omission. Ignoring § 18(a), however, the proponents of "scheme" liability seek to imply into § 10(b) a cause of action that holds one defendant, usually a commercial counterparty, liable because another defendant, usually the issuer, makes a misstatement or material omission to the market.

Section 18(a) imposes liability on a defendant who "shall make *or cause to be made*" a statement that is "false or misleading with respect to any material fact" in "any application, report or document filed" pursuant to the 1934 Act, including the financial statements at issue here. 15 U.S.C. § 78r(a). In contrast, in § 10(b), Congress did not prohibit "causing" a deceptive device—*e.g.*, causing an issuer's misrepresentation in its financial statements—but instead stopped at the defendant who actually "use[s] or employ[s]" the deceptive device in connection with a purchase or sale of securities.

Although § 18(a) reaches a broader array of defendants than § 10(b), Congress imposed a critical limitation to preclude open-ended damages awards to the market as a whole: the plaintiff must have actually read and relied upon the misstatement. Section 18(a) limits potential plaintiffs to "any person . . . who, *in reliance upon such statement*, shall have purchased or sold a security at a price which was affected by such statement, for damages *caused by such reliance*." *Id.* (emphasis added). Because the statute expressly refers to the plaintiff's reliance on the specific statement – in addition to the requirement of an effect on the market price – it can be satisfied only by proof of individual reliance, rather than by the fraud-on-the-market presumption. *See, e.g., In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d

256, 283-84 (3d Cir. 2006); *Heit* v. *Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968).[9]

By contrast, in private § 10(b) actions, the reliance requirement is not a statutory creation but rather was judicially implied to delimit the implied cause of action. *See Basic, Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988). Allowing fraud on the market to satisfy reliance in a § 10(b) action does not render § 18(a) a practical nullity *only* because the class of defendants that can be sued in a § 10(b) private civil action is narrower than the group that can be sued in the express § 18(a) action. "Scheme" liability obliterates that essential limitation. No private plaintiff would sue a secondary actor under § 18(a), which requires actual reliance, if "scheme" liability allows a § 10(b) claim against the same defendant for causing a misstatement *without* proving actual reliance. Indeed, this is why petitioner, like all other plaintiffs alleging scheme liability, did not sue under § 18(a), even though petitioner describes "[t]he scheme to defraud here" as "causing false financial statements to be published." Pet. Br. 21-22. That fact speaks volumes about the improper nullifying impact petitioner's § 10(b) theory would have on § 18(a). *See United Sav.*, 484 U.S. at 375.

2. § 9(e): Like § 18(a), § 9(e) reaches beyond defendants who use or employ the specified unlawful devices. Section 9(a)-(c) prohibits certain enumerated forms of market manipulation, and § 9(a)(4) also prohibits false or misleading statements by a dealer, broker, "or the person selling or

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[9] An earlier proposed version of § 18(a) required only that the market price of the security be affected by the misstatement. That provision was amended to add the additional requirement of "eyeball" reliance in response to criticism of the potentially sweeping liabilities under the earlier proposal. *See* Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. Rev. 435, 464-65 & nn.191 & 192 (1984). *Accord In re MDC Holdings Sec. Litig.*, 754 F. Supp. 785, 798 (S.D. Cal. 1990); *Hoover* v. *Allen*, 241 F. Supp. 213, 221-23 (S.D.N.Y. 1965).

offering [a security] for sale" made "for the purpose of inducing the purchase or sale" of that security. 15 U.S.C. § 78i(a)-(c). Unlike § 10(b), § 9(e) creates additional express private civil liability for "[a]ny person who *willfully participates in* any act or transaction" prohibited by §§ 9(a)-(c). 15 U.S.C. § 78i(e) (emphasis added). As *Pinter*, 486 U.S. at 650 n.26, held, § 9(e) shows "Congress knew of the collateral participation concept" and thus that concept should not be implied into other civil liability provisions. Nonetheless, even the class of defendants under § 9(e) does not include "one who aids or abets a violation." *See Central Bank*, 511 U.S. at 179.

"Scheme liability" would improperly render important restrictions on the express § 9(e) action meaningless, by creating instead a more easily satisfied § 10(b) implied action. For example, § 9 is limited to specified manipulative practices and a narrow class of false or misleading statements made directly between buyers and sellers of securities, *see, e.g.*, *Robbins* v. *Banner Indus., Inc.*, 285 F. Supp. 758, 761 (S.D.N.Y. 1966), for the specific "purpose of inducing the purchase or sale" of the specific security purchased or sold by the defendant. 15 U.S.C. § 78i(a)(4). Thus, unlike § 10(b), a purchaser in the secondary market could not sue even an issuer under § 9 over its periodic financial reports. *See Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 788 (2d Cir. 1951) (§ 9(a)(4) "impose[s] restrictions somewhat like those imposed on a suit under § 11 of the 1933 Act").

3. §§ 11 and 12 of the 1933 Act: Section 11 of the 1933 Act creates a claim against only enumerated defendants – directors of the issuer, underwriters, and those who sign or consent to be named in a registration statement – for misrepresentations or omissions in a registration statement for an offering of new securities. *See* 15 U.S.C. § 77k(a). It does not apply to others who cause or assist misstatements by the enumerated defendants. *See Central Bank*, 511 U.S. at 179.

Sections 12(a)(1) and 12(a)(2) claims are directed against anyone who "[o]ffers or sells a security . . . by means of a prospectus or oral communication" that is false or misleading, or in violation of registration requirements, to be sued by "the person purchasing such security from him." 15 U.S.C. § 77*l*(a)(1)-(2). The class of defendants is again limited, to those in privity with the plaintiff or who directly solicit the plaintiff's purchase at least in part for their own financial gain. This Court rejected extending § 12 liability to someone "'whose participation in the buy-sell [securities] transaction is a substantial factor in causing the transaction to take place.'" *Pinter*, 486 U.S. at 649; *see Central Bank*, 511 U.S. at 179. An implied cause of action for "scheme" liability under § 10(b) against companies engaged in commercial transactions with the issuer or seller would undo Congress's policy choices limiting §§ 11 and 12 claims.[10]

B. "Scheme" Liability Would Nullify Statutory Provisions Intended To Be Enforceable Only By The Government.

In stark contrast, other provisions of the 1933 and 1934 Acts allow *only* the SEC and the Justice Department, *not* private litigants, to sue the very defendants targeted by private "scheme" liability. Petitioner's argument would obliterate these policy decisions made by Congress.

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[10] *Herman & MacLean* v. *Huddleston*, 459 U.S. 375 (1983), does not suggest otherwise. That case involved a § 10(b) claim against an accounting firm for its own allegedly false statements. *See id.* at 377. In a footnote, dictum suggests that § 10(b) may apply to "*certain* individuals who play a part in *preparing* the registration statement." *Id.* at 386 n.22 (emphases added). A person that plays a "part in preparing" a false registration statement may arguably be "using or employing" that false statement under § 10(b). But commercial counterparties play no "part in *preparing*" the issuer's financial statements, and that is not the theory of "scheme" liability. Rather, "scheme" liability rests on the assertion that the implied § 10(b) action extends to the commercial counterparty's undisclosed transaction itself. Nothing in *Herman & MacLean* remotely supports that.

1. Provisions Of The Original 1933 And 1934 Acts: When Congress wanted to create liability for employing fraudulent "schemes," it did so expressly. Section 17(a) of the 1933 Act thus renders it unlawful "to employ any device, *scheme*, or artifice to defraud, or . . . to engage in any *transaction*, practice, or *course of business* which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a)(1), (3) (emphasis added). Thus, unlike § 10(b), subparts (1) and (3) of § 17(a) expressly cover defendants who employ a scheme or engage in a course of business, rather than use or employ a deceptive device itself.[11]

Section 17(a) reaches any sale in the primary and secondary markets. *See Gustafson*, 513 U.S. at 577-78; *United States* v. *Naftalin*, 441 U.S. 768, 777-78 (1979). The SEC has regularly used § 17(a) against secondary actors, *see, e.g.*,

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[11] It is particularly inappropriate to construe § 10(b) or Rule 10b-5 as if § 10(b) had used language included in § 17(a) but *omitted* from § 10(b). *See Central Bank*, 511 U.S. at 179-80, 184. The reach of Rule 10b-5 is limited by § 10(b). *See, e.g., Santa Fe Indus.*, 430 U.S. at 473-74 (a "complaint states a cause of action under any part of Rule 10b-5 *only if* the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute") (emphasis added); *Hochfelder*, 425 U.S. at 213-14 (Rule 10b-5's "scope cannot exceed the power granted the [SEC] by Congress under § 10(b)"). This limit applies even when Rule 10b-5 uses the same language as § 17(a). *Compare Aaron* v. *SEC*, 446 U.S. 680, 695-97 (1980) (scienter not required under §§ 17(a)(2) & (3)), *with Hochfelder*, 425 U.S. at 212-14 (scienter required for all § 10(b) actions despite use of same language in Rule 10b-5(b) & (c) as in §§ 17(a)(2) & (3)). Moreover, the administrative history of Rule 10b-5 shows that it was promulgated merely to clarify that the SEC could sue defrauding purchasers in addition to defrauding sellers of stock. *See Hochfelder*, 425 U.S. at 212 n.32; *Blue Chip Stamps*, 421 U.S. at 766-67 (Blackmun, J., dissenting); Milton V. Freeman, *Administrative Procedures*, 22 Bus. Law. 891, 922 (1967); Milton V. Freeman, *Foreword*, 61 Fordham L. Rev. S1, S1-S2 (1993). There was no intent to create a private cause of action, much less one against secondary actors. *See Hochfelder*, 425 U.S. at 196 ("there is no indication that Congress or the Commission when adopting Rule 10b-5, contemplated such a remedy").

Weiss v. *SEC*, 468 F.3d 849, 855-56 (D.C. Cir. 2006), and against fraudulent schemes. *See, e.g., In re Schmidt*, Rel. No. 8061, 2002 WL 89028, at *7-8 (S.E.C. Jan. 24, 2002).

Most important for this case, § 17(a) does *not* create a private right of action. *See, e.g., Finkel* v. *Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992) (citing cases). If Congress wanted private civil claims for "scheme" liability, it would have provided an express cause of action for § 17(a) claims, just as it did for the express but narrower §§ 11 and 12 claims. It did not. Instead, § 17(a)'s sweeping prohibitions are bounded by the SEC's and the Justice Department's sound prosecutorial discretion, which ensures a focus on genuinely serious wrongdoing and the public interest. This is in marked contrast to the pursuit of private remedies, where the private plaintiffs' bar has a powerful economic incentive to sue everyone. The detrimental effect of those incentives on the competitiveness of American business is obvious: in the last decade, even *after* the PSLRA, 2,465 issuers have been named as defendants in securities fraud class actions out of approximately 6000 companies listed on the major U.S. exchanges. *See Final Report*, at 30. "Scheme" liability would cause those already astounding numbers to multiply, given that all companies do business with other companies.[12]

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[12] Like § 17(a), other provisions of the 1933 and 1934 Acts also expressly authorize the government, but *not* private civil plaintiffs, to pursue a variety of secondary actors. The 1934 Act grants the SEC express statutory authority to pursue registered broker-dealers and their "associated persons" who "willfully aided, abetted, counseled, commanded, induced, or procured" violations of the securities laws. 15 U.S.C. §§ 78o(b)(4)(E), 78u-2(a)(2). *See also Central Bank*, 511 U.S. at 183. The SEC also can sue ongoing and future violators of the securities laws "and any other person that is, was, or would be *a cause* of the violation, due to an act or omission the person knew or should have known would *contribute* to such violation." 15 U.S.C. § 78u-3(a) (emphasis added). The SEC and Justice Department also can pursue those who "made or caused to be made" false statements in required filings or

2. § 20(e): In the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress rejected proposals to overrule *Central Bank* and expand the scope of private civil liability under § 10(b) to secondary actors. Instead, in enacting § 20(e) of the 1934 Act, 15 U.S.C. § 78t(e), Congress expressly provided that *only* in actions brought by the SEC, "any person who knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." Thus, Congress gave the SEC, but *not* private plaintiffs, an express claim for conduct ("substantial assistance") against defendants who had no duty to disclose.

This congressional decision has only one of two meanings. Either Congress chose to ratify the *Central Bank* holding, *supra*, at 9-11, that *private* plaintiffs could not sue defendants under § 10(b) for conduct when those defendants had no duty to disclose. Or, as petitioner and its amici would have it, Congress believed that what was called "aiding-and-abetting" conduct before *Central Bank* would be called "primary" conduct thereafter, so that there was no need to overrule *Central Bank* for private plaintiffs. The latter view is nonsensical and contradicts the PSLRA's drafting history.

If the scope of primary liability under § 10(b) were as broad as petitioner contends, then § 20(e) would be at best surplusage. The SEC would always sue for "scheme" liability under § 10(b) because § 20(e) has additional requirements of "knowingly providing substantial assistance."

Moreover, as the Senate Report states, Congress made a deliberate policy decision to deny private plaintiffs the authority to bring suits for conduct against secondary actors who had no duty to disclose because "amending the 1934 Act

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broker-dealer registrations. *See* 15 U.S.C. §§ 78o(b)(4)(A), 78u-2(a)(3), 78ff(a). None of these provisions creates a private right of action.

to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to [the] goal of reducing meritless securities litigation." S. Rep. No. 104-98, at 19 (1995). There is no hint that the same claims could proceed simply by relabelling them as claims for primary conduct. To the contrary, in the PSLRA, Congress sought to avoid the kinds of chilling effects caused by litigation risk that "scheme" liability claims in private class actions would create. *See* H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets."); *see also* 143 Cong. Rec. S10475, S10477 (daily ed. Oct. 7, 1997) ("if our markets are to remain ahead of those in London, Frankfurt, Tokyo, or Hong Kong, we must create uniformity and certainty"); *supra*, at 6-8.

More generally, Congress is presumed to know the law when it legislates. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 379 (1982). Thus, Congress knows that "[a]s a general rule, the principle of *stare decisis* directs [this Court] to adhere not only to the holdings of [its] prior cases, but also their explications of the governing rules of law." *County of Allegheny* v. *ACLU*, 492 U.S. 573, 668 (1989) (Kennedy, J., concurring); *see also Carey* v. *Musladin*, 127 S. Ct. 649, 655 (2006) (Stevens, J., concurring) (*stare decisis* includes "explanatory language" for the Court's ruling even if "such guidance . . . may not have been strictly necessary as an explanation of the Court's specific holding").

Central Bank explicated why aiding-and-abetting was inconsistent with the necessary elements for primary liability. First, *Central Bank* held: "As in earlier cases considering *conduct* prohibited by § 10(b), we again conclude that the statute prohibits *only* the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177 (emphasis added). Commercial counterparties do not make statements to the market about the issuer or have the duty to disclose necessary for liability for a material omission.

Second, *Central Bank* held that defendant-by-defendant reliance is an essential element of primary liability:

> [R]espondents' argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance. A plaintiff must show reliance on *the defendant's misstatement or omission* to recover under 10b-5. Were we to allow the aiding and abetting action proposed in this case, *the defendant* could be liable without any showing that the plaintiff relied upon *the aider and abettor's* statements or actions. Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.

Id. at 180 (emphasis added; citations omitted). As we show *infra*, at 28-29, "scheme" liability cannot be reconciled with the defendant-by-defendant reliance required by *Central Bank*.

Less than a month after *Central Bank* was issued on April 19, 1994, then-SEC Chairman Levitt told Congress that *Central Bank* required defendant-by-defendant reliance under § 10(b): "As the Supreme Court emphasized in *Central Bank of Denver*, a private plaintiff under Rule 10b-5 must show, *defendant by defendant*, that the plaintiff reasonably relied on the defendant's misstatement or omission." *Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs*, 103d Cong. 51 (1994) (statement of Arthur Levitt, Chairman, SEC) (emphasis added). And, former SEC Chairman David Ruder told Congress that "[a]ctive assistance to securities law fraud by accountants, banks, lawyers and others who cannot be classified as participants or controlling persons would no longer be actionable." *Id.* at 107. Congress chose not to overrule either *Central Bank*'s definition of the scope of § 10(b) liability or its requirement of defendant-by-defendant reliance.

To the contrary, in the PSLRA, Congress adopted the principle of *Central Bank* that elements of § 10(b) primary liability must be satisfied by reference to the conduct of the particular defendant. Specifically, the PSLRA required that "the act or omission *of the defendant* alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (emphasis added). As we show *infra*, at 29-30, "scheme" liability cannot be reconciled with defendant-by-defendant loss causation.

3. Sarbanes-Oxley: In the Sarbanes-Oxley Act enacted in 2002, Congress again rejected allowing private civil plaintiffs to use § 10(b) to sue secondary actors. Members of Congress proposed "to give the victims of fraud the right to sue those who aid issuers in misleading and defrauding the public." H.R. Rep. No. 107-414, at 53 (2002). Congress was urged to "undo the Central Bank case and bring back aiding and abetting." *Hearing on H.R. 3763 Before the H. Comm. on Fin. Servs.*, 107th Cong. 63 (2002).[13] It was broadly asserted that "when a person adds substantial value to a fraudulent course of conduct—in other words, contributes in a substantive way to its success—then liability is necessary and appropriate to achieve both deterrence and compensation." *Id.* at 485-86. Congress rejected these proposals for expanding the § 10(b) implied private cause of action. Instead, Congress empowered *the SEC* to direct to shareholders any proceeds it obtained from the secondary actors it sued under § 20(e). 15 U.S.C. § 7246(a). From 2002 to 2006, the SEC recovered $8 billion, including from aiders

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[13] Former Senator Metzenbaum proposed "to restore aiding and abetting liability for those who contribute to fraud but are not the primary culprit." *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. 1037 (2002). Senators Shelby and Durbin proposed to create express private liability against "persons that aid or abet violations" of § 10(b) of the 1934 Act. 148 Cong. Rec. S6584 (daily ed. July 10, 2002).

and abettors, for distribution to shareholders. See SEC, *2006 Performance and Accountability Report* 23 (Nov. 2006), *available at* http://www.sec.gov/about/secpar2006.shtml. *See also Interim Report*, at 71 ("The United States has the toughest administrative enforcement of securities laws in the world.")[14]

Congress's repeated decisions not to modify *Central Bank* in private civil suits is at least "entitled to a good deal of weight." *Blue Chip*, 421 U.S. at 749. Indeed, "[i]t is the federal lawmaker's prerogative . . . to . . . shape the contours of . . . § 10(b) private actions." *Tellabs*, 127 S. Ct. at 2512. Legislative acquiescence is particularly strong here because, "[o]nly one month after" *Central Bank* was decided "Congress held its first hearings on this precise issue. Exhaustive hearings have been held on the issue at various times since then[;]" and Congress has rejected various bills to overrule *Central Bank*. *Bob Jones Univ.* v. *United States*, 461 U.S. 574, 600-01 (1983). "In view of its prolonged and acute awareness of so important an issue," *id.*, Congress has decided that *Central Bank* provides the proper rule of decision in § 10(b) private actions.

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[14] As petitioner and its *amici* note, the 1933 and 1934 Acts refer in several places explicitly to misrepresentations, omissions, conduct, and acts rather than to a "manipulative or deceptive device or contrivance." Petitioner and its *amici* incorrectly contend that these references prove that Congress intended the language of § 10(b) to cover "scheme" liability. Pet. Br. at 18-21; Regents Br. at 17-20, 24; Ohio Br. at 15-20; Ark. Br. at 12-14. This argument is a red herring. No one disputes that § 10(b) applies to "conduct." But for a § 10(b) private civil claim to be based on conduct, the conduct must itself be "deceptive or manipulative" and satisfy "*all* of the requirements for primary liability under Rule 10b-5." *Central Bank*, 511 U.S. at 191. Petitioner and its *amici* contend that participating in a "scheme" is "deceptive" conduct. Nothing in any of the statutory provisions cited by petitioner or its *amici* addresses, expressly or implicitly, whether participating in a "scheme" constitutes "deceptive" conduct under § 10(b), or satisfies the other requirements for primary liability, such as reliance and loss causation. Those provisions are therefore irrelevant.

C. "Scheme" Liability Cannot Be Reconciled With The Elements Of Primary Liability In A § 10(b) Cause Of Action.

Central Bank holds: "Any person or entity, including a lawyer, accountant, or bank, *who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies* may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191 (first emphasis added). As *Central Bank* describes, the line between private primary liability and aiding-and-abetting requires that the deceptive "device or contrivance" used or employed by the particular defendant itself satisfy *all* of the requirements for § 10(b) primary liability. A plaintiff cannot mix and match (1) one device or contrivance used or employed by defendant A to satisfy the deception element against defendant A with (2) defendant B's different device or contrivance to satisfy the *other* elements of primary liability against defendant A, including reliance.

In particular, when a commercial counterparty's allegedly deceptive conduct or statements to third parties other than investors merely assist, enable, or otherwise cause an issuer's misstatement, and the reliance, causation, and other elements are satisfied only by the issuer's misstatement, the defendant has committed only aiding and abetting. *See Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 173-76 (2d Cir. 1998) (because investors did not rely on auditor's false but undisclosed statement to issuer that issuer's financial results were accurate, auditor's statement constituted aiding and abetting, not primary liability); *Filler* v. *Hanvit Bank*, 156 F. App'x 413, 415-16 (2d Cir. 2005) (summary order) (although banks sent "false loan confirmations" to auditor, investors did not rely on these).

1. "Scheme" Liability Is Incompatible With *Central Bank*'s Reliance Requirement.

Even when a defendant has used or employed a deceptive device, such as a misstatement, but that statement is *not* disclosed to investors, the defendant itself has not made "a material misstatement (or omission) *on which a purchaser or seller of securities relies*." *Central Bank*, 511 U.S. at 191 (emphasis added). Under *Central Bank*, reliance upon the public statements of issuers and auditors is insufficient to satisfy the reliance element to hold a different, silent defendant liable as a primary violator. *See id.* at 180 ("A plaintiff must show reliance on *the defendant's misstatement or omission* to recover under 10b-5."). Lack of reliance on a secondary actor is no different just because the defendant is relabeled from an aider and abettor to a schemer. Such a defendant's conduct or statements are still unknown to the plaintiff and the market and that defendant still has no relationship that creates a duty to disclose.[15]

The fraud on the market doctrine is of no assistance in establishing reliance against "scheme" liability defendants. That doctrine applies only to "publicly available information" from the defendant. *Basic*, 485 U.S. at 247; *see Dinsmore* v. *Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 843 (2d Cir. 1998) (investors did not rely on attorneys' misrepresentations to SEC that were not public). The

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[15] As *Central Bank* recognized, 511 U.S. at 177, 180, it would be particularly inappropriate to apply the word "indirectly" from the preamble to § 10 to make the reliance requirement easier to satisfy in a § 10(b) private damages action. The reliance requirement does not arise from the language of § 10(b) and thus does not apply when the SEC sues. *Supra*, at 14 & n.17. Rather, the courts created a reliance requirement to keep the judicially implied private damages action within "careful limits." *Central Bank*, 511 U.S. at 180. It would be improper to apply the "indirectly" language of § 10(b) to weaken the important reliance limit on the private damages action when the language of § 10(b) does not itself create a private damages action in the first place.

transactions of commercial counterparties would normally not be publicly available information. *Stoneridge* illustrates this. The market knew about Charter's financial statements but was unaware of any conduct by respondents.

2. "Scheme" Liability Is Incompatible With The PSLRA's Loss Causation Requirement.

As noted above, the PSLRA requires that the plaintiff allege and prove that "the *act or omission of the defendant* alleged to violate this chapter caused the loss." 15 U.S.C. § 78u-4(b)(4). Loss causation is satisfied only when the issuer's stock price declined because of the particular defendant's deceptive act or omission. *Dura*, 544 U.S. at 344; *see also Lattanzio* v. *Deloitte & Touche LLP*, 476 F.3d 147, 158 (2d Cir. 2007) (plaintiffs "have not alleged facts to show that *Deloitte's misstatements*, among others (made by Warnaco) that were much more consequential and numerous, were the proximate cause of plaintiffs' loss") (emphasis added).

In this case, as in other commercial counterparty cases, the "act or omission of the defendant" vendors was never disclosed to either inflate or deflate the market price of the issuer's stock. Nonetheless, petitioner alleges that *Charter's* much broader "*financial statements* caused the price of Charter's stock to be inflated" and that respondents should be held responsible for all $7 billion in damages flowing from Charter's financial statements, Pet. Br. at 38, even though respondents' transactions allegedly increased operating cash flow by only $17 million. Scientific-Atlanta Cert. Opp. App. at 33 (Am. Cmpl. ¶ 79.) Because Charter's statements and omissions were not "the act or omission *of the defendant*" respondents, the PSLRA loss causation requirement is not satisfied.

This is confirmed by *Dura*, which held that loss causation is at least as demanding as common law proximate cause. *See*

544 U.S. at 343-44. The common law requires "a direct causal connection." *Anza* v. *Ideal Steel Supply Corp.*, 126 S. Ct. 1991, 1996-98 (2006). "Scheme" liability, however, seeks to hold a commercial counterparty liable because (a) its commercial transaction was (b) improperly accounted for by the issuer in (c) the issuer's much broader financial statements, and (d) those broader financial statements inflated the issuer's stock price. That is the antithesis of "a direct causal connection." *Cf. Holmes* v. *SIPC*, 503 U.S. 258, 287 (1992) (Scalia, J., concurring) ("'for want of a nail, a kingdom was lost' is a commentary on fate, not the statement of a major cause of action against a blacksmith"). Rather, it is classic aiding-and-abetting. Thus, under *Central Bank*, it provides no basis for a claim under the § 10(b) implied action.

CONCLUSION

The decision of the court of appeals should be affirmed.

Respectfully submitted,

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STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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BRIEF FOR CHANGE TO WIN AND THE CtW INVESTMENT GROUP AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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IN THE

Supreme Court of the United States

No. 06-43

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR CHANGE TO WIN AND THE CtW INVESTMENT GROUP AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

"*Actions lie louder than words.*"
– Carolyn Wells, American author and poet (1862-1942)

INTEREST OF *AMICI* [1]

Change to Win is an alliance of seven partner unions and six million workers, united to build a new movement of

[1] This brief was not authored in whole or in part by counsel for a party. No person or entity other than *amici curiae*, their members, or their counsel made a monetary contribution to the preparation or submission of this brief. The parties' letters of consent to the filing of this brief have been filed with the Court.

working people that can meet the challenges of the global economy and restore the American Dream: a paycheck that can support a family, affordable health care, a secure retirement and dignity on the job. The seven partner unions are: International Brotherhood of Teamsters, Laborers' International Union of North America, Service Employees International Union, UNITE HERE, United Brotherhood of Carpenters and Joiners of America, United Farm Workers of America, and United Food and Commercial Workers International Union. The Change to Win Investment Group was established in February 2006 to monitor corporate activity and protect the interests of Change to Win workers in various Taft-Hartley and public pension funds with approximately $1.5 trillion in assets.

In recent years, funds like those associated with *amici* have suffered substantial losses due to securities misconduct and have utilized the remedies afforded them under the federal securities laws to protect their beneficiaries. These actions have included §10(b) suits—both class actions in which such funds sought lead plaintiff status under the Private Securities Litigation Reform Act of 1995 and individual suits.

Amici have a significant interest in assuring that federal securities laws protect the interests of investors in accord with Congress' intent. If allowed to stand, the court of appeals' ruling in this case would virtually immunize banks, brokers, accountants, law firms, and others from liability in many cases. The view that those crafty enough to benefit from participating in a securities fraud can escape liability by carefully avoiding a public statement directly conflicts with the broad language and purposes of the antifraud provisions. Indeed, it is precisely with respect to such secret schemes that the antifraud provisions are needed the most. The federal securities laws are not designed to allow the most cunningly devised white collar fraud to be rewarded with immunity from liability.

SUMMARY OF ARGUMENT

The complaint in this action alleges that Defendants Scientific-Atlanta and Motorola engaged knowingly in a scheme with Charter Communications to enter into sham transactions for the sole purpose of falsely portraying Charter's financial performance to investors and the public at a critical time. Purporting to apply this Court's ruling in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), the court below held that Section 10(b)'s proscription against "any manipulative or deceptive device or contrivance" imposes liability only where there is "a misstatement or a failure to disclose by one who has a duty to disclose." *In re Charter Comms., Inc.*, 443 F.3d 987, 992 (8th Cir. 2006). Despite the allegations of the complaint, the court characterized the arrangement between Charter and the vendors as "an arm's length business transaction," noted that the vendors were not alleged to have "issue[d] any misstatement relied upon by the investing public," found that they "were not under any duty to disclose information useful in evaluating Charter's true financial condition" and upheld dismissal of the claims against them. *Id.*

Amici submit this brief because this "*Speak No Evil*" rule created by the court of appeals profoundly affects the honesty and integrity of the securities markets as well as the ability of defrauded investors to recover their losses. The significance of this issue cannot be underestimated. The rule eviscerates the federal regime of investor protection and threatens to turn back the clock to the 1920's. The Enron, WorldCom, and other devastating corporate financial scandals of recent years have demonstrated the sophistication and ingenuity with which securities fraud may be perpetrated through sham transactions and seriously undermined confidence in our markets and our regulatory system. Immunizing intentionally deceptive conduct just because the perpetrator has not itself

made any direct public statement guts the central purpose of the federal securities laws and encourages fraud.

I. The "*Speak No Evil*" rule conflicts with the broad purpose, structure and wording of federal securities law. The Securities Exchange Act of 1934 was enacted "to insure the maintenance of fair and honest markets" in securities. 15 U.S.C. §78b. Consistent with that broad purpose, Section 10(b)'s broad scope covers the "use" or "employ[ment]" by "any person," whether "directly or indirectly," of "any manipulative or deceptive device or contrivance." 15 U.S.C. §78j(b). The Court repeatedly has recognized the broad antifraud purposes of federal securities law. *SEC v. Zandford*, 535 U.S. 813, 821 (2002); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477 (1977). Nothing in the statute explicitly requires fraudulent statements or omissions and the Court has twice found Congress did not adopt limited meanings of the words "device" and "contrivance." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 & n.20 (1976); *Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Moreover, the various statutory provisions show that Congress knew how to limit the reach of securities law to specific statements but deliberately declined to do so in Section 10(b).

II. The "*Speak No Evil*" rule conflicts with the common law underlying Section 10(b). Section 10(b) was derived from the common law and this Court repeatedly has relied upon the common law in interpreting its provisions. *E.g., Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 343-44 (2005); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975). In the absence of any contrary direction by Congress, Section 10(b) should at least be construed consistent with the common law's understanding of fraud. *Safeco Ins. Co. of America v. Burr*, 2007 U.S. LEXIS 6963, **20-21 (June 4, 2007). Indeed, in enacting Section 10(b), Congress meant to enact a level of investor protection and

ethical standards that go beyond the common law. *See Basic Inc. v. Levinson*, 485 U.S. 224, 244 n.22 (1988); *Herman & Maclean v. Huddleston*, 459 U.S. 375, 388 (1983). Under common law, conduct can be just as fraudulent as statements. The conduct at issue here was intended and designed to deceive and therefore clearly falls within the range of actions proscribed by the common law of fraud. Restatement of Torts, Second, §§525, 550; *accord* W. Page Keeton et al., PROSSER AND KEETON ON TORTS §106 (5th ed. 1984); *United States v. Colton*, 231 F.3d 890, 898-903 (4th Cir. 2000).

III. Although pure "silence" is not actionable as fraud under the common law or Section 10(b) absent a duty to disclose, the conduct at issue here cannot legitimately be characterized or analyzed as pure "silence." The complaint alleges the vendor-Defendants engaged in deceptive transactions designed and intended to inflate Charter's financial performance and dupe the public and investors. These were not arms' length, legitimate transactions that merely aided and abetted Charter's fraud. They had no legitimate business purpose but were fabricated for one purpose and one purpose only—to communicate a lie to investors purchasing the company's securities. These were acts of deceit as effective in achieving their deceptive purpose as any false statements could have been. Indeed, their effectiveness may only have been exceeded by their cunning and audacity. What is at issue here is not "silence" but deceptive conduct prohibited by Section 10(b) and Rule 10b-5, as it would be under common law.

IV. This Court did not in *Central Bank*, or in any other case, confine fraudulent conduct under Section 10(b) and Rule 10b-5 to misstatements or omissions. In *Central Bank*, this Court declared that merely lending aid or assistance to others who commit fraud, without engaging in any deceptive acts of one's own, does not violate the statute or rule. The Court did not hold an act cannot be a prohibited deceptive

device or contrivance unless one publicly lies about it. To the contrary, this Court consistently has upheld liability under Section 10(b) and subsections (a) and (c) of Rule 10b-5 for fraudulent conduct not involving a misstatement or omission.

ARGUMENT

I. THE "SPEAK NO EVIL" RULE CONFLICTS WITH THE WORDING, PURPOSE, AND STRUCTURE OF THE FEDERAL SECURITIES LAWS

The court of appeals concluded that "[a] device or contrivance is not 'deceptive' within the meaning of §10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *In re Charter Comms., Inc.*, 443 F.3d at 992.[2] Although the court did not explicitly invalidate subsections (a) and (c) of Rule 10b-5, its holding necessarily renders those subsections redundant and undermines every judgment and claim based upon them.[3] The court of appeals' ruling was not based on the wording or legislative history of Section 10(b), the structure or other provisions of the federal securities laws, the wording of Rule 10b-5, the common law of fraud or deceit, or the plain meaning of the word "deceptive." It was based *solely* on its view that this Court

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[2] As this Court stated with respect to another attempt to add an element to a securities antifraud provision, "[t]he short answer is that Congress did not write the statute that way." *United States v. Naftalin*, 441 U.S. 768, 773 (1979) (construing §17(a) of the Securities Act of 1933).

[3] Subsection (b) of Rule 10b-5 prohibits "any untrue statement of a material fact" or any "omi[ssion] to state a material fact necessary in order to make the statements made . . . not misleading." 17 C.F.R. §240.10b-5(b). The court of appeals' ruling would require such an untrue statement or omission in all Rule 10b-5 cases. Thus, the ruling amounts to a determination that liability cannot be predicated on subsections (a) or (c) independently of subsection (b).

has adopted a specific, term-of-art definition of "deceptive" for purposes of Section 10(b). It has not. Nor should it.

The Securities Exchange Act of 1934 was enacted "to insure the maintenance of fair and honest markets" in securities. 15 U.S.C. §78b.[4] Consistent with that broad purpose, Section 10(b)'s broad scope covers the "use" or "employ[ment]" by "any person," whether "directly or indirectly," of "any manipulative or deceptive device or contrivance." 15 U.S.C. §78j(b). The broad purpose of the statute is plain from its broad delegation of authority to the Securities and Exchange Commission to promulgate whatever rules regarding such conduct it may find "necessary or appropriate" for the "protection of investors" or even the "public interest" at large.

This Court consistently has recognized the broad antifraud purposes of the federal securities laws. *E.g., Zandford*, 535 U.S. at 821 (emphasizing broad language and interpretation of antifraud provisions); *O'Hagan*, 521 U.S. at 658 (Congress intended "to insure honest securities markets and thereby promote investor confidence"); *Santa Fe*, 430 U.S. at 477 ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices"); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972) (antifraud provisions "are broad and, by

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[4] Many of the abuses of the 1920's, which Congress sought to eliminate by enacting the securities laws, involved manipulative or deceptive conduct designed to separate a stock's price from its true value. *See* 15 U.S.C. §78b(3) ("Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control," which undermines credit, tax, and banking systems). The Court noted in *Santa Fe* that Section 10(b) was "aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." 430 U.S. at 473 n.13 (quoting S. Rep. No. 792, 73d Cong., 2d Sess., 6 (1934)). The sham transactions here were designed to preclude Charter's stock price from reflecting its true value and served no other useful function.

repeated use of the word 'any,' are obviously meant to be inclusive. The . . . 1934 Act . . . embrace[s] a 'fundamental purpose . . . to achieve a high standard of business ethics in the securities industry'") (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) ("'We believe that §10 (b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws'") (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967) (emphasis in original)); *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 366 (1963) ("It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail . . . .").

Nothing in the wording of Section 10(b) limits it to fraudulent statements or omissions. This Court twice has found Congress did not adopt limited meanings of the words "device" and "contrivance" and such terms should be accorded their ordinary dictionary meanings. *Hochfelder*, 425 U.S. at 199 & n.20; *Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980).[5] The ordinary meaning of "device" or "contrivance" is not limited to a statement or omission. Nor is there

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[5] As the Court found, the 1934 dictionary definition of "device" was "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and the definition of "contrivance" was "[a] thing contrived or used in contriving; a scheme, plan, or artifice." *Hochfelder*, 425 U.S. at 199 n.20. The Court also found the 1934 dictionary definition of "scheme" was "[a] plan or program of something to be done; an enterprise; a project; as, a business *scheme* [, or a] crafty, unethical project," and the definition of "artifice" was a "[crafty] device; trickery; also, an artful stratagem or trick; artfulness; ingeniousness." *Aaron*, 446 U.S. at 696 n.13 (emphasis in original).

anything in the ordinary meaning of the word "deceptive" that even vaguely implies it must involve a public statement or omission.

To the contrary, the statutory words broadly connote conduct involving a plan or scheme. Although the words "device" and "contrivance" themselves may include an element of deception or trickery in common usage, the addition of the modifying adjective "deceptive" requires that they must. The adjective "deceptive" indicates the "devices" or "contrivances" *must be misleading*, not that they *must consist of public statements or omissions*, as the court of appeals concluded. *Santa Fe*, 430 U.S. at 472-74 ("The language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"). In *Hochfelder*, this Court cautioned against the very thing the court of appeals did here—"add a gloss to the operative language of the statute quite different from its commonly accepted meaning." 425 U.S. at 199.[6]

Although this Court has found that "manipulative" is a term of art with a specific meaning under Section 10(b), it has not found that "deceptive" is a term of art and has never accorded it anything other than its commonly accepted meaning. *E.g., O'Hagan*, 521 U.S. at 653 (misappropriators "deal in deception" because they "'dupe[]' or defraud[] the principal"); *Santa Fe*, 430 U.S. at 472 (equating "commonly accepted meaning" of "fraud" with statutory term "deceptive").[7] Therefore, the "Speak No Evil" rule is inconsistent

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[6] "To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another . . . . After all, legislation when not expressed in technical terms is addressed to the common run of men . . . ." *Addison v. Holly Hill Fruit Prods, Inc.*, 322 U.S. 607, 617-18 (1944).

[7] That Congress intended the antifraud provisions to be read according to their ordinary or common law meanings also is evident from the

with the wording and purposes of the antifraud laws and this Court's admonition to read those laws flexibly in accordance with Congress' broad remedial purposes.

In enacting the federal securities laws, Congress knew well how to proscribe misstatements or omissions when that was its objective. The securities laws as originally enacted are replete with prohibitions directed against misstatements or omissions. *See* Securities Act of 1933, §§8(d), 11(a), 12(a), 24, 15 U.S.C. §§77h(d), 77k(a), 77l(a), 77x; Securities Exchange Act of 1934, §§9(a)(4), 18, 32(a), 15 U.S.C. §§78i(a)(4), 78r, 78ff(a).

Congress in 1933 and 1934, however, also knew well how to more broadly proscribe deceptive conduct when that was its objective. *See* Securities Act of 1933, §17(a), 15 U.S.C. §77q(a) (prohibiting "any device, scheme, or artifice to defraud" and "any transaction, practice, or course of business which operates or would operate as a fraud or deceit"); Securities Exchange Act of 1934, §§10(b), 15 U.S.C. §78j(b) (prohibiting "any manipulative or deceptive device or contrivance"), 9(a)(1), 15 U.S.C. §78i(a)(1) (prohibiting conduct "for the purpose of creating a false or misleading appearance").[8]

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statutes themselves. The title of Section 17 of the Securities Act of 1933, 15 U.S.C. §77q, the section upon which Rule 10b-5 was based, is "Fraudulent Interstate Transactions" and the original heading of subsection 17(a) was "Use of interstate commerce for purpose of fraud or deceit." Congress continues to have this understanding. In 2000, Congress amended the heading of subsection 17(a) to read "Anti-fraud and anti-manipulation enforcement authority." In 2000, Congress also added language to Section 10 of the 1934 Act, 15 U.S.C. §78j, recognizing it gives the SEC authority to promulgate rules "that prohibit fraud, manipulation, or insider trading."

[8] Two years after enacting the 1934 Act, Congress amended the statute to add another broad prohibition against engaging in "any manipulative, deceptive, or other fraudulent device or contrivance." 15 U.S.C. §78o(c)(1).

Congress has continued to enact securities fraud provisions based on its understanding that conduct other than misstatements or omissions can be "deceptive." In 1938, it prohibited brokers and dealers from "engag[ing] in any fraudulent, deceptive, or manipulative act or practice, *or* mak[ing] any fictitious quotation." 15 U.S.C. §78o(c)(2) (emphasis added). In 1968, Congress made it "unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading *or* to engage in any fraudulent, deceptive, or manipulative acts or practices" in connection with tender offers. 15 U.S.C. §78n(e) (emphasis added). In 1993, Congress enacted a narrow prohibition against certain misstatements or omissions by government securities brokers and dealers in a statute that already broadly prohibited "manipulative, deceptive, or other fraudulent device[s] or contrivance[s]" by such persons. 15 U.S.C. §78o(c)(7). Again, in 1998, Congress preempted certain actions under state law that alleged *either* that the defendant made "an untrue statement or omission of a material fact" *or* that the defendant "used or employed any manipulative or deceptive device or contrivance." 15 U.S.C. §§77p(b), 78bb(f)(1). Congress referred to such actions collectively as those that allege "misrepresentation, omission, *or* manipulative or deceptive conduct." *Id.* at §78bb(f)(5)(E) (emphasis added).

In enacting the Private Securities Litigation Reform Act of 1995, Congress adopted a proportionate liability scheme for private securities fraud actions under which "knowing" violators generally are jointly and severally liable while non-knowing violators are proportionately liable. *See* 15 U.S.C. §78u-4(f). Under that scheme, the definition of a "knowing" violation differs depending on whether the action is "based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading" *or* is "based on *any [other] conduct*." *Id.* at §78u-4(f)(10)(A) (em-

phasis added). Thus, Congress continues to understand that conduct other than speech or omissions can be fraudulent and to enact legislation accordingly.[9]

II. THE "SPEAK NO EVIL" RULE CONFLICTS WITH THE COMMON LAW DERIVATION OF THE ANTIFRAUD STATUTE

In interpreting Section 10(b) and Rule 10b-5, this Court has referred for guidance to the common law, from which the antifraud provisions were derived. *E.g., Dura Pharmaceuticals*, 544 U.S. at 343-44; *Blue Chip Stamps*, 421 U.S. at 744. This is in accordance with the well-established rule of statutory construction that when Congress does not define words commonly understood at common law, courts must infer Congress intended to incorporate the common law meanings of the relevant terms. *Safeco*, 2007 U.S. LEXIS 6963, at **20-21 ("general rule [is] that a common law term in a statute comes with a common law meaning, absent anything pointing another way"); *id.* at **40-41 ("There being no indication that Congress had something different in mind, we have no reason to deviate from the common law understanding in applying the statute"); *Beck v. Prupis*, 529 U.S. 494, 500-01 (2000); *Neder v. United States*, 527 U.S. 1, 20-23 (1999); *Morissette v. United States*, 342 U.S. 246, 263 (1952) ("absence of contrary direction may be taken as satisfaction

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[9] In devising the PSLRA liability scheme for securities fraud committed by multiple actors, Congress enacted safeguards to protect investment banks, brokers, accountants, lawyers and others who engage in securities fraud violations through conduct rather than public statements, from exposure to unlimited liability. To be held jointly and severally liable, they must engage in the fraudulent conduct "with actual knowledge of the facts and circumstances that make the conduct . . . a violation of the securities laws." 15 U.S.C. §78u-4(f)(10)(A)(ii). Moreover, recklessness is not sufficient to constitute such knowing conduct. *Id.* at §78u-4(f)(10)(B). Further, they are accorded contribution rights to proceed against others liable for the same damages. *Id.* at §78u-4(f)(8).

with widely held definitions, not as a departure from them"). In *Neder*, this Court found the words "any scheme or artifice to defraud" in the federal mail fraud, wire fraud, and bank fraud statutes were left undefined and, therefore, Congress implicitly incorporated their common law meanings with respect to an action for fraud. 527 U.S. at 20-23.[10] Just as the Court looks to the common law of fraud for purposes of interpreting the wording of those statutes, it looks to the common law of fraud for purposes of interpreting similar wording in the securities laws.

Further, the Court has recognized that the statute's derivation from common law accounts for its elements. Because Section 10(b) requires deceit or fraud, the elements of common law fraud—scienter, materiality, reliance, causation, and damages—must be part of any Rule 10b-5 claim. For example, in *Hochfelder*, this Court found that the statutory deception requirement mandates a showing of scienter in order to state a Rule 10b-5 claim precisely because deception connotes common law fraud and common law fraud requires scienter. *See* 425 U.S. at 197; *see also Aaron*, 446 U.S. at 695.

Although the statutory deception requirement generally has been equated with common law fraud, this Court has acknowledged that Congress intended to enact a broad remedial provision that would go *beyond* the limitations of the common law protection. *See Basic*, 485 U.S. at 244 n.22 ("Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims, and are in part designed to *add to* the protections provided investors by the common law")

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[10] On the basis of this rule of construction and the application of common law fraud to the federal bank fraud statute, the Second Circuit found an affirmative statement is not required for liability under that statute and defendants' scheme to defraud, executed through affirmative deceptive acts, violated the statute even in the absence of a preexisting legal duty to disclose. *See Colton*, 231 F.3d 890.

(citations omitted) (emphasis added); *Huddleston*, 459 U.S. at 388 ("the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to *rectify perceived deficiencies* in the available common-law protections by establishing *higher standards of conduct* in the securities industry") (emphasis added).[11] It is for this reason the Court consistently has emphasized that Congress intended the antifraud provision to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Capital Gains Research Bureau*, 375 U.S. at 195 (quoted in *Superintendent of Ins.*, 404 U.S. at 12 and *Affiliated Ute*, 430 U.S. at 151).

The common law did not limit fraud to actual speech but recognized that acts can be as deceptive as words and misrepresentations can be made through either. *Stewart v. Wyoming Cattle Ranche Co.*, 128 U.S. 383, 388 (1888) ("The gist of the action [of common law deceit] is fraudulently producing a false impression upon the mind of the other party; and if this result is accomplished, it is unimportant whether the means of accomplishing it are words or acts of the defendants, or his concealment or suppression of material facts not equally within the knowledge or reach of the plaintiff"). Under the common law of misrepresentation or deceit, the definition of "misrepresentation" included "not only words spoken or written but also *any other conduct that amounts to*

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[11] *See also Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975) ("although derived from it, the 10b-5 action is not coterminous with a common law fraud action"); *Green v. Wolf Corp.*, 406 F.2d 291, 303 (2d Cir. 1968) (federal courts "have gone far beyond the limits of the common law in imposing liability under [Rule] 10b-5"). The SEC agrees. *See In re Cady, Roberts & Co.*, 40 S.E.C. 907, 910 (1961) ("Section 10(b) of the Exchange Act and Rule 10b-5, issued under that section, are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit").

an assertion not in accordance with the truth." Restatement of Torts, Second, §525, comment b (emphasis added).[12] Thus, words and acts were on an equal footing in terms of common law fraud: "words or conduct asserting the existence of a fact constitute a misrepresentation if the fact does not exist." *Id.*

For example, if an automobile dealer turns the odometer back from 60,000 miles to 18,000 miles on a car offered for sale, his *conduct* constitutes a misrepresentation. *Id.*, illustration 1; *District Motor Co. v. Rodill*, 88 A.2d 489, 494 (D.C. Ct. App. 1952) (turning back odometer "was an act of deceit, calculated to destroy or conceal evidence highly significant" to plaintiff's purchase); *accord Leonard v. Springer*, 197 Ill. 532, 64 N.E. 299 (Ill. 1902) (representation "proceed[s] from the action or conduct of the party charged, which is sufficient to create upon the mind a distinct impression of fact, conducive of action. The most usual and obvious example is an oral, written or printed statement. *But a statement is by no means necessary. Any conduct capable of being turned into a statement of fact is a representation. There is no distinction between misrepresentations effected by words and misrepresentations effected by other acts*") (quoting BIGELOW ON FRAUD, at p. 467) (emphasis added); *Salzman v. Maldaver*,

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[12] *See generally Reichert Estate*, 356 Pa. 269, 274, 51 A.2d 615, 617 (Pa. 1947) (under common law fraud, "[a]s a general rule, fraud consists in anything calculated to deceive, whether by single act or combination, or by suppression of truth, or a suggestion of what is false, whether it be by direct falsehood, or by innuendo, by speech or silence, word of mouth, or look or gesture. It is any artifice by which a person is deceived to his disadvantage"); *People ex rel. Chicago Bar Assn. v. Gilmore*, 345 Ill. 28, 46, 177 N.E. 710, 717 (Ill. 1931) (same); *Philadelphia Workingmen's Sav. Loan & Bldg. Assn. v. Wurzel*, 355 Pa. 86, 94, 49 A.2d 55, 59 (Pa. 1946) (under common law, fraud consisted of "misrepresentation by word or deed"); *Sachs v. Blewett*, 206 Ind. 151, 156, 185 N.E. 856 (Ind. 1933) (under common law fraud, "[t]here must be some fraudulent, overt act, *or* failure to act when duty requires it, *or* a breach of trust or confidence") (emphasis added).

315 Mich. 403, 24 N.W. 2d 161 (1946) (stacking aluminum sheets to conceal those corroded in the middle); *Lindberg Cadillac Co. v. Aron*, 371 S.W. 2d 651 (Mo. Ct. App. 1963) (painting over cracked engine block on car). "There being no indication that Congress had something different in mind, [there is] no reason to deviate from the common law understanding" that fraud can be committed through conduct as well as statements. *Safeco*, 2007 U.S. LEXIS 6963, at **40-41.

Common law fraud also includes acts taken to conceal, create a false impression, mislead, or otherwise deceive in order to "prevent[] the other [party] from acquiring material information," even in the absence of a fiduciary, statutory, or other independent duty to disclose material information. Restatement of Torts, Second, §550; *accord* W. Page Keeton et al., PROSSER AND KEETON ON TORTS §106 (5th ed. 1984) ("Any words or acts which create a false impression covering up the truth, or which remove an opportunity that might otherwise have led to the discovery of a material fact . . . are classed as misrepresentation, no less than a verbal assurance that the fact is not true"); *Colton*, 231 F.3d at 898-903 (rejecting claim defendants could not be liable for "scheme or artifice to defraud" under federal bank statute because they made no affirmative misrepresentations and owed no duty to disclose). The Defendants here are alleged to have engaged in conduct that would have constituted such fraudulent concealment at common law.

By engaging in the sham transactions at issue in this case with the knowledge and intention that investors would rely on the financial statements that reflected those transactions as genuine, Defendants' conduct amounted to an assertion regarding the financial condition of Charter that was not in accordance with the truth. Indeed, it was alleged to communicate a deliberate lie. Just as the act of rolling back an odometer is a deceptive act taken for the purpose of misrep-

resenting the car's condition as better than it actually is, the phony transactions here were deceptive acts taken for the purpose of misrepresenting Charter's condition as better than it actually was.

The court of appeals, in stating that it could find no case imposing Section 10(b) liability on a business "that entered into an arms' length non-securities transaction," missed the point. These were not "*arms' length*," *legitimate transactions*. These were *acts of deceit*, sham transactions calculated to create upon the minds of investors the distinct impression that Charter's financial condition met analysts' estimates and to conceal contrary evidence highly significant to investors' purchasing decisions. Defendants' conduct, both in its crafty design and its execution, constituted purposeful deception. It represented a falsehood just as effectively as any words could have communicated.[13] It therefore should be prohibited by Section 10(b) and Rule 10b-5.

III. THE "SPEAK NO EVIL" RULE FAILS TO RECOGNIZE THAT DECEPTIVE CONDUCT IS NOT MERE SILENCE

The "Speak No Evil" test ignores the fact that affirmative fraudulent conduct is not mere "silence" and, because it cannot be characterized legitimately as "silence," it does not require an underlying duty to be actionable under Section 10(b). The idea that our securities markets could be subjected to fraudulent devices, schemes, artifices, acts, practices, and courses of conduct of this kind is completely inconsistent with the antifraud, market integrity, and ethics-promoting purposes of the federal securities laws.

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[13] *See Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951) ("Defendant's contention that only express misrepresentations or half-truths are unlawful fails to look at the fact that an implied misrepresentation is just as fraudulent as an express one").

The common law of deceit recognized several different kinds of fraudulent misrepresentations. One of these has just been discussed above—misrepresentation by words or conduct, or what may be called "conduct fraud." Restatement of Torts, Second, §525. Two other types involve a failure to disclose: misrepresentation by means of partial statements, or what may be termed "omission fraud," *id.* at §529;[14] and simple nondisclosure, or what may be termed "pure silence fraud," *id.* at §551.[15]

Each of these types of fraud has a corresponding underlying duty. "Conduct fraud" is premised on the general tort duty not to commit affirmative fraudulent acts. "Omission fraud" is premised on one's "duty to exercise reasonable care to disclose . . . matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading." *Id.* at §551(2)(b). "Pure silence fraud" is premised on one's "duty to exercise reasonable care to disclose matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." *Id.* at §551(2)(a).

In enacting Section 10(b) in the wake of the stock market crash of 1929, Congress intended to expand upon the common law and enact stronger protections and higher ethical

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[14] The Restatement of Torts defines such a misrepresentation as "[a] representation stating the truth so far as it goes but which the maker knows or believes to be materially misleading because of his failure to state additional or qualifying matter is a fraudulent misrepresentation." Restatement of Torts, Second, §529.

[15] "One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question." Restatement of Torts, Second, §551(1).

standards than existed previously. Accordingly, the statutory term "deceptive devices or contrivances" must at least encompass all the various types of fraud recognized under common law and cannot impose duties higher than those imposed by common law for each particular type of fraud. Properly interpreted, Rule 10b-5 aptly embraces all forms of misrepresentation and their attendant underlying duties. Subsection (b)'s proscriptions against making an "untrue statement of a material fact" and "omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" reflect "conduct fraud" and "omission fraud," respectively.[16] The prohibitions against "employ[ing] any device, scheme, or artifice to defraud" and "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit" in subsections (a) and (c) reflect both "conduct fraud" and "pure silence fraud."

Each type of fraud encompassed by Rule 10b-5 is premised on the same duty as its common law corollary. The principle announced by this Court that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak" (*Chiarella v. United States*, 445 U.S. 222, 234-35 (1980)) and "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5" (*Basic*, 485 U.S. at 244 n.22), is based on the same principle as existed under common law. *See* Restatement of Torts, Second, §551.[17] But just as the

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[16] In light of the wording of subsection (b) ("the statements made") and the wording of the common law on which it is based ("partial or ambiguous statement"), "omissions" under Rule 10b-5(b) actually require predicate statements. Therefore, the common reference to "misstatement or omission" with respect to Rule 10b-5 connotes a situation in which some affirmative statement is made. Thus, "omissions" are different from "pure silence fraud" or "conduct fraud" under subsections (a) and (c) of Rule 10b-5.

[17] In the context of pure silence, the Court in *Chiarella* unexceptionally noted that "at common law, . . . one who fails to disclose material infor-

common law principle was based on several different types of underlying duties, so is the principle under Section 10(b) and Rule 10b-5. Although courts often fail to make the proper distinctions, *not all silences are the same*. *Stewart*, 128 U.S. at 388 ("mere silence is quite different from concealment").[18] The underlying duties are also not all the same. Pure silence is different from omission silence, and both are different from silence accompanied by fraudulent conduct.

For example, insider trading cases under Section 10(b) are based on common law "pure silence fraud," which in turn is premised on the underlying duty of a fiduciary to affirmatively disclose material information prior to a transaction with a beneficiary. *See, e.g., Chiarella*, 445 U.S. at 227-28.[19] Such cases, therefore, fall under subsections (a) and (c) of Rule 10b-5 as fraudulent conduct not involving a misstatement or omission but involving a particular duty—in this instance, an insider fiduciary duty—recognized at common

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mation prior to the consummation of a transaction commits fraud only when he is under a duty to do so." 445 U.S. at 227-28.

[18] *Accord Colton*, 231 F.3d at 899 ("[T]he common law clearly distinguishes between concealment and nondisclosure. The former is characterized by deceptive acts or contrivances intended to hide information, mislead, avoid suspicion, or prevent further inquiry into a material matter. The latter is characterized by mere silence"); *id.* at 899 n.2 (noting courts often fail to distinguish between passive nondisclosure and active concealment, leading to incorrect statements that latter requires duty to disclose); *O'Conner v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 n.6 (10th Cir. 1992) (noting cases "do not always distinguish between fraud by conduct and fraud by misrepresentation or omission").

[19] As transplanted into the context of the federal securities laws, the "deception" arising from the pure silence of an insider using material, non-public information derives from the "inherent unfairness involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (quoting *In re Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)).

law. *See id.* at 228 (quoting Restatement of Torts, Second, §551(2)(a)). Churning, unsuitability, and unauthorized or excessive trading cases against brokers are additional examples of Section 10(b) cases falling within subsections (a) and (c) of Rule 10b-5 that are based on common law "pure silence fraud" (if no statements are made) and its corresponding fiduciary duty to disclose. *See, e.g., O'Conner*, 965 F.2d at 897-98; *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 599-600 (2d Cir. 1978). As the SEC has found, "churning is in itself a scheme or artifice to defraud and a fraudulent and deceptive device within the meaning of Rule 10b-5." *In re Trujillo*, 1987 SEC LEXIS 1978, **60-61 (April 23, 1987); *id.* at *61 (same for unsuitable trading).

On the other hand, scheme, practice, or course of conduct cases under Section 10(b) are based on common law "conduct fraud," which is not based on a fiduciary duty but rather the independent, general duty not to commit deceit upon others. *See United States v. Hunt*, 2006 U.S. Dist. LEXIS 64887, **9-19 (S.D.N.Y. Sept. 6, 2006) (liability under subsections (a) and (c) of Rule 10b-5 does not depend on fiduciary duty); *SEC v. Santos*, 355 F. Supp. 2d 917, 919-20 (N.D. Ill. 2003) (same).

There has never been any indication by this Court that "conduct fraud" has no place under Section 10(b) and that, in moving from common law to the federal securities laws, an entire category of fraud did not make the trip. The court of appeals' fundamental error is that it failed to apprehend that conduct beyond statements or omissions can be "deceptive," and that *this is not a "pure silence fraud" case but rather a "conduct fraud" case*. This led it to apply the *wrong duty to the wrong type of fraud*. The court of appeals found devices or contrivances could not be "deceptive" absent "some misstatement or a failure to disclose by one who has a duty to disclose," 443 F.3d at 992, yet it failed to ascertain whether a duty arose from Defendants' affirmative conduct. The court

apparently assumed this was a "pure silence fraud" case and that the only duty it had to look for was the type of duty applicable to such cases—a fiduciary duty or similar duty of trust and confidence. *But the Chiarella-type duty applicable to pure silence cases is not applicable here. See Colton*, 231 F.3d at 899 ("common-law principle that, in the absence of an independent disclosure duty, 'nondisclosure is not fraudulent, presupposes mere silence, and is not applicable where, by words or conduct, a false representation is intimated or any deceit practiced'") (quoting 37 Am. Jur. 2d FRAUD AND DECEIT §174 (1968)).

The court of appeals, therefore, mistakenly applied a "pure silence fraud" duty to a "conduct fraud" claim. Defendants' fraudulent conduct amounted to a misrepresentation and concealment under well-established common law principles. Defendants had as much a duty to refrain from fraudulent conduct as they did to refrain from fraudulent statements. Under the circumstances alleged here, their actions conveyed a lie as effectively as any words could have.[20]

Just as one who becomes an insider inherits a duty to disclose or abstain from trading and one who speaks inherits a duty to speak truthfully, one who acts inherits a duty to act nondeceptively. Requiring the more stringent fiduciary-type duty applicable to "pure silence fraud" cases for the fraudulent conduct at issue here would be to impose upon plaintiffs a higher burden than would be imposed upon them at common law. It also would limit liability to a greater extent than

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[20] This case is distinguishable from an insider trading case, which is appropriately analyzed as a "pure silence fraud" case because mere trading while in the possession of material, non-public information is not itself deceptive in nature. No false assertion is conveyed. On the contrary, acts that are themselves deceptive because they convey "an assertion not in accordance with the truth," Restatement of Torts, Second, §525, comment b, such as Defendants' acts here, do not constitute mere silence but rather affirmative misrepresentation.

at common law. "There being no indication that Congress had something different in mind," there is "no reason to deviate from the common law understanding" that liability for fraudulent conduct does not depend on a pre-existing fiduciary duty. *Safeco*, 2007 U.S. LEXIS 6963, at **40-41.

IV. THIS COURT HAS REJECTED THE "SPEAK NO EVIL" RULE

The court of appeals relied on two of this Court's decisions for its view that the Court has limited the term "deceptive" to misstatements or omissions. One of these cases, *Santa Fe*, 430 U.S. 462, did not say or address anything of the kind. The other case, *Affiliated Ute*, 406 U.S. 128, actually held precisely the opposite.[21]

In *Santa Fe*, this Court addressed the issue whether a short-form merger transaction that allegedly lacked a legitimate business purpose and was unfair to minority shareholders could be actionable as a "device, scheme, or artifice to defraud" and an "act, practice or course of business which operates or would operate as a fraud or deceit" under subsections (a) and (c) of Rule 10b-5. *See* 430 U.S. at 467-68. The Court ruled that the statutory words "manipulative or deceptive" used in conjunction with "device or contrivance" meant that the statute only reached conduct that included "some element of deception" (under its commonly accepted meaning) or "manipulation" (under its term of art meaning). *See id.* at 472-77. Significantly, the Court did not, as the court of

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[21] The court of appeals also cited in accord *O'Hagan*, 521 U.S. 642. In *O'Hagan*, the Court held only that a fiduciary who pretends loyalty to a principal "while secretly converting the principal's information for personal gain," engages in fraud prohibited by Section 10(b) and Rule 10b-5. *See* 521 U.S. at 653-55. In addressing this particular circumstance, this Court did not, of course, rule that misappropriation by fiduciaries is the *only* way to violate the statute and rule. It therefore does not support the court of appeals' view that the Court has limited deceptive devices or contrivances to misstatements or omissions.

appeals believed, limit Section 10(b) to misstatements and omissions or invalidate fraudulent conduct liability under subsections (a) and (c) of Rule 10b-5. It merely held that conduct under subsections (a) and (c) had to be fraudulent in nature to be actionable. Clearly, if only subsection (b) of Rule 10b-5 were valid, there would have been no need for the Court to have taken up the question it addressed at all.[22]

In *Affiliated Ute*, this Court rejected the very proposition the court of appeals attributed to it. In that case, the Court found the lower court erroneously had "viewed too narrowly" the conduct of the defendants by restricting liability to their misstatements and omissions pursuant to subsection (b) of Rule 10b-5. *See* 406 U.S. at 151-53. The Court ruled "[i]n the light of the congressional philosophy and purpose," it would "not read Rule 10b-5 so restrictively." *Id.* at 151, 152. Because the defendants' *conduct* amounted to a course of business or scheme that operated as a fraud, they could be held additionally liable under subsections (a) and (c) of Rule 10b-5, even without misrepresentations or omissions. *Id.* at 151-53.

In concluding in *Affiliated Ute* that, although "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact," "*[t]he first and third subparagraphs are not so restricted*," the Court upheld subsection (a) and (c) liability for fraudulent conduct not involving misstatements or omissions. *Id.* at 152-53 (emphasis added) ("It is no answer to urge that, as to some of the petitioners, these defendants may have made no positive representation. . . ."); *accord Hochfelder*, 425 U.S. at 199 n.20 ("scheme to defraud" falls

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[22] The Court acknowledged the case came to it "on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose." *Santa Fe*, 430 U.S. at 474. The Court also acknowledged liability under the statute could be premised upon "deception, misrepresentation, *or* nondisclosure." *Id.* at 476 (emphasis added).

within meaning of "manipulative or deceptive device or contrivance" language of §10(b)).[23] In doing so, the Court's interpretation of liability under Section 10(b) and Rule 10b-5 accords with the common law principle that fraud requires either a representation or a failure to disclosure by one who is under a duty to disclose, but that a "representation" may be communicated either by words or conduct.[24]

The SEC also has consistently interpreted Section 10(b) as proscribing more than misstatements or omissions. In *In re Robert W. Armstrong, III*, the SEC stated:

> *Schemes used to artificially inflate the price of stocks by creating phantom revenue* fall squarely within both the language of section 10(b) and its broad purpose, to 'prevent *practices* that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded,' and nothing in the language of section 10(b) or Rule 10b-5 or in the case law interpret-

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[23] The Court has recognized that the conduct proscribed under subsections (a) and (c) of Rule 10b-5 is within the scope of the statute's prohibition against "manipulative and deceptive devices and contrivances." *Zandford*, 535 U.S. at 816 n.1 ("The scope of Rule 10b-5 is coextensive with the coverage of §10(b)"); *Central Bank*, 511 U.S. at 172 (Rule 10b-5 "casts the proscription [of §10(b)] in similar terms").

[24] In finding that the term "manipulation" in Section 14(e) of the 1934 Act, 15 U.S.C. §78n(e), which prohibits "fraudulent, deceptive, or manipulative acts or practices" in connection with tender offers, requires some misrepresentation, the Court recognized that misrepresentation can occur by word or act. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 7 & n.4 (1985) ("manipulative" and "deceptive" have related meanings). The Court relied on the seminal English case of *Scott v. Brown, Doering, McNab & Co.*, [1892] 2 Q.B. 724, 730 (C.A.), which found deception could occur without the dissemination of false statements, quoting Lord Lopes: "I can see no substantial distinction between false rumours and false and fictitious acts." 472 U.S. at 7 n.4.

> ing them shields a defendant from liability for direct participation in such a scheme.

2005 SEC LEXIS 1497, *23 (June 24, 2005) (emphasis added) (quoting *In re Global Crossing Ltd. Secs. Litig.*, 322 F. Supp. 2d 319, 337 (S.D.N.Y. 2004)).[25] This is precisely the conduct alleged against the Defendants here—*direct participation in a scheme to artificially inflate the price of Charter's stock by creating phantom revenue.*[26]

The *Central Bank* decision did not signal any change in the Court's view of what constitutes a deceptive device or

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[25] *See also SEC v. Dibella*, 2005 U.S. Dist. LEXIS 31762, *11 (D. Conn. Nov. 29, 2005) (SEC arguing subsections (a) and (c) do not involve omissions of any kind, but rather prohibit schemes to defraud, and such fraudulent conduct alone constitutes primary violation regardless whether any material omissions were made); *Robert W. Armstrong*, 2005 SEC LEXIS 1497, at *23 ("A person's conduct as part of a scheme constitutes a primary violation when the person directly or indirectly engages in a manipulative or deceptive act as part of the scheme") (rejecting claim "deception" requires material misstatement or omission); *Cady, Roberts*, 40 S.E.C. at 911 ("These anti-fraud provisions [of Rule 10b-5] are not intended as a *specification of specific acts or practices* which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others") (emphasis added); *id.* at 911 n.12 ("It might be said of fraud that age cannot wither it, nor custom stale its infinite variety").

[26] The SEC has repeatedly used its antifraud rulemaking authority under Section 10(b) to prohibit more than misstatements or omissions. In addition to Rule 10b-5, Rule 10b-1, 17 C.F.R. §240.10b-1, prohibits certain "act[s] or omission[s]" with respect to exempted securities, Rule 10b-3,17 C.F.R. §240.10b-3, prohibits certain "act[s], practice[s], or course[s] of business" by brokers or dealers, Rules 10b-5-1, 17 C.F.R. §240.10b-5-1, and 10b-5-2, 17 C.F.R. §240.10b-5-2, prohibit insider trading and misappropriation, Rule 10b-10, 17 C.F.R. §240.10b-10, prohibits certain broker transactions without proper disclosures, Rule 10b-16, 17 C.F.R. §240.10b-16, prohibits brokers or dealers from extending credit to customers without certain disclosures, and Rule 10b-17, 17 C.F.R. §240.10b-17, prohibits issuers from taking certain actions without making certain disclosures.

contrivance. While *Central Bank* swept away decades of precedent upholding aiding and abetting liability, it did not sweep away the broad antifraud purposes of the federal securities laws or strike down any language in Section 10(b) or Rule 10b-5.

The court of appeals erroneously concluded that *Central Bank* altered the definition of "deceptive" conduct. It did not even address the definition. *Central Bank* stands merely for the proposition that, to be held liable, a defendant must commit a manipulative or deceptive device or contrivance *itself* rather than merely assist *another* to do so. But the decision *did not change the types of conduct that constitute manipulative or deceptive devices or contrivances.* In other words, *Central Bank* concerned the *relationship or connection* between the defendant and the deceptive conduct; it did not alter the *definition* of "deceptive" conduct. *See* 511 U.S. at 166 (question presented was "whether private civil liability under § 10(b) extends as well to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation"); *id.* at 184 ("Aiding and abetting is 'a method by which courts create secondary liability' in persons other than the violator of the statute").

This Court confirmed after *Central Bank* (and consistent with *Affiliated Ute* and *Hochfelder*) that liability may be premised on fraudulent acts, practices, schemes, and courses of business under subsections (a) or (c) of Rule 10b-5, without a public statement by the defendant. As the Court stated in *Zandford*, "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." 535 U.S. at 820 (holding a broker who did not make a misstatement liable under subsections (a) and (c)).[27] The Court has recog-

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[27] Lower federal courts also have held that an affirmative public statement is not required for liability under Section 10(b) and subsections (a) and (c) of Rule 10b-5. *See Colton*, 231 F.3d 890; *SEC v. First Jersey*

nized that, although one cannot be held liable under Section 10(b) for engaging in nondeceptive acts that merely assist others to commit securities fraud, one can be held liable for one's own deceptive conduct in a scheme, practice, or course of conduct to defraud, regardless whether those acts perpetrate the misrepresentation through words or acts.

CONCLUSION

The decision of the court below should be reversed and the matter remanded to the district court for further proceedings.

Respectfully submitted,

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Sec., 101 F.3d 1450, 1471-72 (2d Cir. 1996); *SEC v. Seaboard*, 677 F.2d 1301, 1312 (9th Cir. 1982); *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981) (*en banc*); *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 814-15 (2d Cir. 1975); *Blackie*, 524 F.2d at 903 n.19; *Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971); *Hunt*, 2006 U.S. Dist. LEXIS 64887, at **9-19; *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 869 (S.D. Tex. 2001); *Wenneman v. Brown*, 49 F. Supp. 2d 1283 (D. Utah 1999); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1400 (N.D. Cal. 1995); *In re ZZZZ Best Secs. Litig.*, 864 F. Supp. 960, 964-72 (C.D. Cal. 1994); *Hill v. Hanover Energy, Inc.*, 1991 U.S. Dist. LEXIS 18566 (D.D.C. Dec. 16, 1991); *Duckworth v. Duckworth*, 1991 U.S. Dist. LEXIS 16527, at *16-*18 (S.D. Ga. Oct. 17, 1991); *Cohen v. Prudential-Bache Sec., Inc.*, 713 F. Supp. 653, 661 (S.D.N.Y. 1989); *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 676 F. Supp. 458, 467-70 (S.D.N.Y. 1987); *Clark v. Kidder, Peabody & Co., Inc.*, 636 F. Supp. 195, 198 (S.D.N.Y. 1986).

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No. 06-43

In The
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

MOTION FOR LEAVE TO FILE A BRIEF AS *AMICI CURIAE* AFTER THE FILING DEADLINE AND BRIEF *AMICI CURIAE* OF THE HONORABLE JOHN CONYERS, JR. AND BARNEY FRANK, IN SUPPORT OF PETITIONER

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MOTION FOR LEAVE TO FILE A BRIEF AS *AMICI CURIAE* AFTER THE FILING DEADLINE

Pursuant to Supreme Court Rule 37.3, the Honorable John Conyers, Jr. and Barney Frank, members of the United States House of Representatives and, respectively, the Chairman of the House Committee on the Judiciary and the Chairman of the House Committee on Financial Services, respectfully move the Court for leave to file the brief that follows after the deadline for filing *amicus* briefs supporting Petitioner (June 11, 2007). *Amici* apologize for the late brief. *Amici* had expected the Solicitor General to accept the recommendation of the Securities and Exchange Commission that the United States file an *amicus* brief in support of Petitioner to urge the Court to follow the Commission's long-standing interpretation of the statutory and regulatory provisions at issue in this case. The Solicitor General's decision to follow the political and policy directives of the President rather than to support the Commission's legal position, coupled with testimony by Commission Chairman Cox at a June 26, 2007 oversight hearing before the Committee on Financial Services, has persuaded *amici* of the critical need to give voice to the points made in their brief.

Petitioner's blanket consent to the filing of *amicus* briefs in support of either party or neither party has been filed with the Clerk of the Court, and Petitioner has granted consent to the filing of this brief out of time. Respondents do not object to the filing of this brief. Since Respondents have been granted an extension of time to file

their brief until August 15, 2007, the granting of this motion would not prejudice them.

Respectfully submitted,

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BRIEF OF THE HONORABLE JOHN CONYERS, JR. AND BARNEY FRANK, AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

Pursuant to Rule 37.3 of the Rules of this Court, The Honorable John Conyers, Jr. and Barney Frank, respectfully submit this brief *amici curiae* in support of Petitioner.[1]

INTEREST OF *AMICI CURIAE*

Amici are the Honorable John Conyers, Jr., a member of the United States House of Representatives and the Chairman of the House Committee on the Judiciary, and the Honorable Barney Frank, a member of the United States House of Representatives and the Chairman of the House Committee on Financial Services. Both *amici* file this brief in their official capacities as committee chairmen.

The Committee on the Judiciary has jurisdiction over the federal courts and the Department of Justice. The Department of Justice is responsible, among other things, for the criminal prosecution of the anti-fraud provisions of

[1] Pursuant to Rule 37.6 of the Rules of this Court, Petitioner's consent to the filing of *amicus* briefs is on file with the Clerk of Court. Petitioner has consented to the filing of this brief out of time. Respondents do not object to the filing of this brief. This brief was not authored, in whole or in part, by counsel for either party. Matthew Wiener of the law firm of Cuneo Gilbert & LaDuca, LLP – counsel of record for AARP, Consumer Federation of America, and U.S. PIRG in submitting a separate *amicus* in support of Petitioner in this case – and Jonathan W. Cuneo, Pamela Gilbert and Michael Lenett of that firm assisted in the preparation of this brief, as did Deborah Silberman and Joshua Kotin of the House Committee on Financial Services. No person other than *amici* contributed monetarily to the preparation or submission of this brief.

the federal securities laws. *See, e.g.*, *Tellabs, Inc. v. Makor Issues & Rights*, No. 06-484, slip op. at 1, 168 L. Ed. 2d 179 (2007).

The Committee on Financial Services has jurisdiction over the federal laws that regulate the nation's capital markets – including the statute at issue in this case, the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (Exchange Act) – and it has legislative oversight authority over the Securities and Exchange Commission (Commission), which is responsible, among other things, for the civil enforcement of the Exchange Act's anti-fraud provision. *See, e.g.*, *Tellabs*, slip op. at 1.

Amici play a significant role in the development of federal securities law and in the operation of the federal courts and, therefore, have an interest in the means by which the anti-fraud provisions of the federal securities laws are applied by the courts. *Amici* have an interest in the proper differentiation of constitutional responsibilities among the Executive, the Congress and this Court and wish to bring certain information to the attention of the Court.

SUMMARY OF ARGUMENT

The interpretation of Section 10(b) and Rule 10b-5 adopted by the Court of Appeals and urged by Respondents ultimately rests on policy considerations at odds with the statutory text that should more appropriately be addressed to Congress than to this Court. In its merits brief, Petitioner argues that the conduct at issue is prohibited by the plain language of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and its companion Commission

regulation, Rule 10b-5, 17 C.F.R. § 240.10b-5, and urges that any change to the substantive law should be made by legislative action and not by the courts. This contention is correct.

ARGUMENT

Amici are mindful of the Court's admonition that *amici* raise only relevant matters not already brought to the attention of the Court by the parties, *see* SUP. CT. R. 37.1. Therefore the focus of this brief is to clarify the role of Congress and the relationship among the Executive, the Congress and the Court in seeking to alter the scope of the anti-fraud provisions of the Exchange Act. Section 10(b) of the Exchange Act makes it unlawful for "any person, directly or indirectly" to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b).

Section 10(b) of the Exchange Act and Commission Rule 10b-5 (in particular, subsections (a) and (c)) proscribe conduct of the sort alleged in Petitioner's complaint and by plaintiffs in other prominent securities fraud cases to have come before the federal courts. *See, e.g.*, *Regents of the Univ. of California v. Credit Suisse First Boston (USA)*, 482 F.3d 372, 392-93 (5th Cir. 2007), *sub nom. The Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., pet. for cert. filed* (Apr. 5, 2007) (No. 06-1341). The Court of Appeals' interpretation of the law in this case runs directly counter to a plain reading of the statute.

Section 10(b) of the Exchange Act makes it "unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . , any manipulative or

deceptive device or contrivance in contravention of" such rules and regulations as the Commission may find are "necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b). Rule 10b-5, promulgated under this provision, forbids the use, "in connection with the purchase or sale of any security," of "any device, scheme, or artifice to defraud" or any other "act, practice, or course of business" that "operates . . . as a fraud or deceit."

As the Commission pointed out in its brief *amicus curiae* in support of positions that favor petitioner, *Simpson v. Homestore, Inc.*, No. 04-55665 (9th Cir. Oct. 22, 2004), *available at* www.sec.gov/litigation/briefs/homestore_102104.pdf, this Court has stated repeatedly that Section 10(b) should be construed "'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972), quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963)); *accord Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971); *see also Santa Fe Indus. v. Green*, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices.").

This Court also has stated its belief that "§ 10 (b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Bankers Life*, 404 U.S. at 11 n.7 (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)); *see also*

Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (stating that Section 10(b) is "a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.'").

As a whole, Rule 10b-5 encompasses all of the authority granted to the Commission in Section 10(b). *See Zandford*, 535 U.S. at 816, n.1 ("The scope of Rule 10b-5 is coextensive with the coverage of § 10(b). . . ."). Thus, if conduct is covered by Rule 10b-5, it is necessarily covered by Section 10(b). Rule 10b-5 should be afforded controlling weight. *See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984) (upholding EPA's construction of Clean Air Act term "stationary source").

The Commission has been consistent in its support for the proposition that, under appropriate circumstances, a defendant who committed deceptive acts as a part of a scheme to defraud investors may be liable under Rule 10b-5, even if that defendant did not directly issue fraudulent statements. The Court can find a well-articulated statement of the Commission's position in its *amicus* briefs in the *Simpson v. Homestore, Inc.* case, *supra*.

Commission Chairman Christopher Cox recently testified before the House Financial Services Committee that, at the recommendation of staff and following a three to two vote of the Commissioners, the Commission recommended to the Solicitor General of the United States that he file an *amicus* brief in support of Petitioners. *See* Excerpts from Hearing on Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission Before the House Comm. on Financial Services, 110th Cong., 1st Sess., June

26, 2007 (consisting of complete text of questions and answers cited or quoted in Brief) (CQ Transcriptions, Inc.), at App. 3. In response to a request by Representative Deborah Pryce for comment on the *Stoneridge* case (*Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*), Chairman Cox noted that the *Stoneridge* case was on all fours with the 2004 *Homestore* case, in which the Commission voted unanimously to file an *amicus* brief. He made the astute point that "[l]aw has to have some objective meaning. It can't be just a question of how we all feel about it" and that laws should not be so "effervescent as to change with" the change in political composition of the Commission. *Id.* at App. 4.

In response to later questioning about the Commission's decision to recommend that the Solicitor General file a brief in support of Petitioner, Chairman Cox said:

> And so I did not reflexively follow the unanimous decision of 2004, but rather looked carefully at what was before me. . . . What is going on in that case, though is that we are focused on when conduct is fraudulent, and whether conduct can be fraudulent. I think the commissioners believe it can. And also the circumstances of a particular case and whether or not that case should go forward.

Id. at App. 6.

The Solicitor General rejected the Commission's specific recommendation that the United States file an *amicus* brief in support of Petitioner and urge the Court to follow the Commission's long-standing interpretation of the statutory and regulatory provisions at issue. Disturbingly, this appears to have been done as a result of White House intervention. Allan Hubbard, director of the President's National Economic Council, told reporters on a

conference call on June 12, 2007 that the President personally weighed in with his view that it is important to reduce unnecessary lawsuits and that federal securities regulators are in the best position to sue. *See* Marcy Gordon and Pete Yost, *Bush Gave Policy Views on Top Court Case,* ASSOC. PRESS NEWSWIRES, June 12, 2007. Mr. Hubbard said "[w]e are a society that is overly litigious. And that is very harmful for our economy and very harmful for investors." According to Mr. Hubbard, the President's policy views were conveyed to the Solicitor General by Deputy White House counsel William Kelley. "On the policy matter, there was a difference of opinion that was in the administration. Ultimately, the president makes up his own mind. He shared his opinion with the solicitor general." *Id. See also* Greg Stohr, *Bush Administration Rebuffs Investors at High Court,* BLOOMBERG, June 12, 2007.

The Solicitor General's decision to follow the political and policy directives of the President rather than to support the Commission's legal position plots a dangerous course that has persuaded *amici* of the critical need to bring these developments to the Court's attention.

A number of commentators have called for the Court to decide this case by reference to policy considerations nowhere found in the statute. *See, e.g.*, Ted Frank, *Arbitrary and Unfair*, WALL ST. J., May 31, 2007, at A-14. No doubt Respondents and many of their supporting *amici* will ask the Court to substitute one policy argument or another in lieu of the clear statutory text, much as several lower courts have done in rejecting scheme liability. *See, e.g.*, *Credit Suisse First Boston*, 482 F.3d at 392-93 (5th Cir. 2007); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. and Motorola, Inc. (In re: Charter Communications, Inc. v. Stoneridge Investment Partners, LLC)*, 443

F.3d 987, 992-93 (8th Cir. 2006), *cert. granted*, 127 S. Ct. 1873 (U.S. Mar. 26, 2007) (No. 06-43). That will be an invitation to engage in precisely the sort of policy-based judicial activism this Court has repeatedly condemned in statutory interpretation cases. *See, e.g.*, *NLRB v. Ky. River Cmty. Care, Inc.*, 532 U.S. 706, 720-21 (2001) (Scalia, J.).

The separate powers created by the Constitution invest the different branches of government with distinct roles delegated to them by the Constitution. It is not for the Executive or the Judicial branches of our government to formulate legislative policies; that function is the exclusive province of the Congress. *See Tennessee Valley Auth. v. Hill,* 437 U.S. 153, 194 (1978). It is then for the Executive to administer the laws and for the courts to enforce them. *Id.* The branch of government to which Respondents and their *amici* should direct their policy arguments is Congress. The Committee on Financial Services of the U.S. House of Representatives stands ready to facilitate through hearings a discussion of whether to amend Section 10(b) to immunize from liability persons who knowingly engage, directly or indirectly, through conduct or speech, in manipulative or deceptive acts as a part of a scheme to defraud investors.

Unless and until Congress so amends Section 10(b), however, the Court should honor the legislative policies established by the Congress reflected in the clear language of the statute, and as reflected in the Commission's rules, as well as this Court's precedents. That outcome, we respectfully submit, compels the reversal of the judgment of the Court of Appeals.

CONCLUSION

For the foregoing reasons, the Court should reverse the judgment of the Court of Appeals.

Regardless of the rule announced in this case, Congress will continue to revisit and review the federal securities laws when necessary. Any congressional action will take place within the structure and with the powers defined by the Constitution. Congress has the constitutional authority and the institutional ability to consider fully the policy interests and the public interests that are implicated in this case.

Respectfully submitted,

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July 30, 2007
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APPENDIX A

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REP. BARNEY FRANK HOLDS A HEARING ON THE SECURITIES AND EXCHANGE COMMISSION – COMMITTEE HEARING

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(CORRECTED COPY: CORRECTS SPEAKERS LIST)

HOUSE COMMITTEE ON FINANCIAL SERVICES HOLDS A HEARING ON THE SECURITIES AND EXCHANGE COMMISSION

JUNE 26, 2007

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WITNESSES: CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

PAUL ATKINS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

ROEL CAMPOS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

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KATHLEEN CASEY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

[*] FRANK: The hearing of the Committee on Financial Services will convene. I am very pleased, along with the ranking members and the others, to welcome all five commissioners.

* * *

PRYCE: Real time? All right. Thank you. Would you like to comment at all – in some of the opening statements, we heard mention of the amicus brief filed by the SEC. My time's expired?

FRANK: Yes, but make it the last question, and get a quick answer.

PRYCE: It's the last question. Do you want to comment on that now? Or would you rather have a more pointed question?

COX: Well, I need a more pointed question just to know which amicus brief you're talking about.

FRANK: Go ahead and point.

PRYCE: All right. The Stoneridge case amicus brief. Thank you.

COX: All right. The Stoneridge case – and you can get a variety of opinions here, because as you know that was three-to-two vote. But the Stoneridge case was very similar to a prior case that the SEC had considered in 2004 called Homestore. It was my view, and it is my view generally with respect to decisions that are recently taken by the SEC, that precedent matters. And because Homestore and Stoneridge were very much on all fours with one another, I thought it important for the SEC to be consistent and be clear on these points.

As I mentioned in my opening statement, I don't believe that SEC rules or policies and so on should be so effervescent as to change with one or two people coming on board. It would be awfully nice if the regulatory process were sufficiently transparent that people would know what to expect. And I think this is doubly so when what we're doing is trying to interpret law, what law means. Law has to have some objective meaning. It can't be just a question of how we all feel about it.

So the SEC, having voted in 2004, just one year before I arrived on this very point, I thought it important for us to be consistent. And I should point out that that 2004 vote was not a three-to-two vote. It was a unanimous vote of the SEC.

PRYCE: Thank you.

Thank you, Mr. Chairman.

* * *

FRANK: The gentleman from Illinois.

May I just ask to the commissioners, I'm very grateful. I know we've been here three hours. We only have a few members who've been very faithful. And I think we can clean this up in about a half hour or so, if that's possible. And I'd very much appreciate your indulgence. And I think we want to be respectful of the members who stay.

The gentleman from Illinois. Thank you.

MANZULLO (?): Thank you, Mr. Chairman.

Long-time listener, first-time caller this afternoon. Mr. Chairman, this past week, I've been to two baseball games out at RFK. I saw the Nationals lose to the Detroit Tigers

last night – far more exciting game, the congressional game. And I paid a lot of attention to the umpires when they were there. And it strikes me that your demeanor today, transitioning from your role as a policymaker to your role now is really – you're calling balls and strikes.

And I noticed in the earlier conversation that you had with Mr. Kanjorski from Pennsylvania, your careful use of language. And I mean that respectfully – not parsing use of language, but careful use of language – how you characterize the American economy as robust and dynamic and so forth, and that you'd sign on to that characterization. But you also said hey, there's more opportunity for us to improve.

You also used that same admonition to the Congress about, well, let's make sure that there's a sense of equity between public company taxation and private company taxation or private equity taxation. And of course people like me, we all tend to hear in your words what we want to hear. And I think that you'll probably see quotations later on about how we've interpreted what you've said in different debates. And in the months to come we'll all recollect, well, we had Chairman Cox here. And he said – and we'll have different recollections of that.

But one of the things that is interesting to me is your high view of what you didn't say, but I think is the doctrine of stare decisis and your decision to move forward with the request in the Stoneridge case, to move forward with the amicus brief request and so forth. Can you just give me your thinking on that? Was that a decision that was, look, I've got this new role. And stability is very, very important here. And I understand that thinking. Or, alternatively, do you believe first and foremost that animating the plaintiffs' bar in this

class action type of environment helps the SEC to do its enforcement? Or is there some rationale in between there?

COX: Well first, thank you for your compliment. And I think your interpretation of what I've been attempting to get across here today is fairly accurate, including the priority that I place on predictability in rulemaking and enforcement from Securities and Exchange Commission. I think it is absolutely vitally important that our actions be noble in advance. Otherwise, there is not law, but something else – a lot of government power being exercised arbitrarily.

I don't think that there's anywhere where it could be more important for there to be predictability and clarity in rulemaking than when it comes to our capital markets, because so much is at stake that people have to make big bets on whether or not what they're doing is the right thing to do. And then they got it wind up the right way. So I think we do a great disservice when we are anything but clear and predictable, rule-based and law-based.

Now, that's not to say that this was an easy case, or that there was an automatic outcome. I think you also put your finger on the fact that sometimes getting it right means undoing what you've done once before. And so I did not reflexively follow the unanimous decision of 2004, but rather looked carefully at what was before me.

The staff recommended that the Commission request the solicitor general's office to file an amicus curiae brief, as you know, in support of the plaintiffs in Stoneridge. The Commission, on May 29 and 30, voted – because we have a seriatim process; it occurred over two days – voted to approve that recommendation. I think it is probably not

well-known that there were two parts to that recommendation in support of the plaintiffs. And on one point, the Commission was unanimous.

So I think all of us paid a great deal of attention to, as you put it, stare decisis. And all of us also paid a good deal of attention to whether or not we had it exactly right. We came out slightly differently as commissioners – well exactly opposite in the end. Although these are closer calls than, as you know, when you push the red button and green button, you're completely one way. That doesn't mean it's always easy. But I think everyone here, whichever way they decided that case – and they're all here, so you can ask them – but I think everyone here is concerned that litigation be used to proper ends; and that we to open a Pandora's Box and so on. What is going on in that case, though is that we are focused on when conduct is fraudulent, and whether conduct can be fraudulent. The commissioners believe it can. And also the circumstances of a particular case and whether or not that case should go forward.

So I hope that provides a little bit more context to . . .

FRANK: Mr. Manzullo (ph), I just would add, the gentleman commented on the precision of the chairman's language. Those of us who served with him can tell you that there was nothing new about his being very precise in his language. We remember similar precision when he was here; probably because when he was here, precision in language stood out by contrast.

The gentleman from North Carolina.

* * *

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No. 06-43

Supreme Court, U.S.
FILED
JUN 11 2007
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

**On Writ of Certiorari
to the United States Court of Appeals
for the Eighth Circuit**

BRIEF OF COUNCIL OF INSTITUTIONAL INVESTORS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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June 11, 2007

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INTEREST OF *AMICUS CURIAE*[1]

The Council of Institutional Investors ("Council") is a not-for-profit association of more than 130 public, labor, and corporate pension funds with assets exceeding $3 trillion. Its members are major long-term shareowners with duties to protect the retirement assets of millions of American workers. The Council is an advocate for strong corporate governance standards. Its members seek to protect plan assets through proxy votes, shareowner resolutions, pressure on regulators, discussions with management, and, when necessary, litigation. The Council has previously appeared as an *amicus* in cases affecting shareowner rights. *See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (U.S., argued Mar. 28, 2007); *Devlin v. Scardelletti*, 536 U.S. 1 (2002); *CalPERS v. Felzen*, 525 U.S. 315 (1999).

The interests of the Council and its members are directly implicated by this case. Congress has recognized that institutional investors are America's largest shareowners and "'have the most to gain from meritorious securities litigation.'" H.R. Conf. Rep. No. 104-369, at 34 (1995) (quoting testimony of Maryellen Andersen, then-treasurer of the Council), *reprinted in* 1995 U.S.C.C.A.N. 730, 733. The Council thus has a strong interest in protecting investors' ability to obtain redress from secondary actors who commit securities fraud.

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* represents that it authored this brief and that no person or entity other than *amicus* or its counsel made a monetary contribution to the preparation or submission of the brief. Counsel for *amicus* represents that counsel for all parties have consented to the filing of this brief. Petitioner has filed with the Clerk a letter granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of respondents to the filing of this brief has been filed with the Clerk.

SUMMARY OF ARGUMENT

The Council does not take a position on the precise legal standard for determining when a so-called "secondary actor" – such as a law firm, accounting firm, investment bank, or counterparty in a fraudulent transaction – is a primary violator of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5. The Council believes, however, that the strict test for primary liability endorsed by some lower courts would have undesirable policy consequences. Under that test, a secondary actor is a primary violator of § 10(b) and Rule 10b-5 only if it makes a misstatement that is publicly attributed to the actor at the time of the plaintiff's investment decision, owes a fiduciary duty to the plaintiff investors, or illegally trades in the issuer's securities. *See, e.g., Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] secondary actor cannot incur primary liability under the [Securities] Act for a statement not attributed to that actor at the time of its dissemination."); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("[I]n order for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made.").[2]

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[2] *See also In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (deception within the meaning of § 10(b) includes only misstatements or failure to disclose by one with a duty to disclose, while manipulation includes only illegal trading in the issuer's securities), *cert. granted*, 127 S. Ct. 1873 (2007) (No. 06-43); *Regents of Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 389-91 (5th Cir. 2007) (a "deceptive" device must involve breach of a duty of disclosure, while "manipulation" requires that the defendant act directly in the market for the relevant security), *petition for cert. pending*, No. 06-1341 (U.S. filed Mar. 5, 2007); *id.* at 394 (Dennis, J., concurring in the judgment) (according to the *Credit Suisse* majority and *Charter Communications*, secondary actors cannot be primary violators unless they "(1) directly make public misrepresenta-

Adoption of the strict test would undercut lessons learned in the aftermath of recent financial scandals regarding the complexity of securities fraud today and the importance of deterring secondary actors from participating in fraud. *See* Point I, *infra*. It would give accountants, investment bankers, lawyers, and other third parties a "safe harbor" for fraud so long as they do not publicly announce their involvement with an issuer's misstatements. *See* Point II, *infra*. Contrary to the reasoning of some courts, the strict test is not required to stem a tide of frivolous litigation against secondary actors. *See* Point III, *infra*. Finally, neither lawsuits against issuers themselves nor SEC enforcement will adequately compensate investors in the face of the strict test. *See* Point IV, *infra*.

ARGUMENT

I. ADEQUATE DETERRENCE OF SECONDARY ACTORS IS CRUCIAL TO PREVENTING FRAUD

A common thread in the massive financial scandals of recent years – such as Enron, WorldCom, Tyco, Adelphia, and Global Crossing – is the involvement of accountants, lawyers, investment bankers, and financial advisers in structuring complex transactions designed to falsify companies' financial statements. *See, e.g.*, Joel S. Demski, *Corporate Conflicts of Interest*, 17 J. Econ. Persp. 51, 65-66 (2003) ("Enron carried out countless highly complex and carefully crafted financial transactions. These all involved selling of additional financial services by consultants, attorneys and investment banks. In many cases, these transactions were designed with no apparent purpose other than manipulating recorded debt and earnings and often provided an opportunity for a financial institution to collect fees on both sides of a transaction.").

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tions; (2) owe the issuer's shareholders a duty to disclose; or (3) directly 'manipulate' the market for the issuer's securities through practices such as wash sales or matched orders").

While large-scale securities fraud is not a new phenomenon, recent scandals have been particularly devastating because they illustrate the failure of outside professionals to check corporate management. *See, e.g.*, John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 Bus. Law. 1403, 1404-05 (2002) (in contrast to prior frauds, which "have not generally disturbed the overall market[,] . . . Enron has clearly roiled the market"; "[b]ehind this disruption lies the market's discovery that it cannot rely upon the professional gatekeepers – auditors, analysts, and others – whom the market has long trusted to filter, verify and assess complicated financial information"). Adoption of the strict test would ignore the role of secondary actors in protecting the integrity of securities markets; the evidence that increased profits from fraud and decreased risks of liability led secondary actors to fail in that role; and the need to establish adequate deterrence of secondary actors.

A. Secondary Actors' Function as Gatekeepers

Academics as well as policymakers have recognized the function of secondary actors as "gatekeepers" in the securities markets. *See, e.g.*, Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program*, Speech at UCLA School of Law (Sept. 20, 2004) (describing "the auditors who sign off on companies' financial data" and "the lawyers who advise companies on disclosure standards and other securities law requirements" as "gatekeepers" and "sentries of the marketplace"), *available at* http://www.sec.gov/news/speech/spch092004smc.htm. These third-party professionals verify companies' statements for investors and enable companies to execute transactions. Their involvement may be public – *e.g.*, certifying financial statements and signing opinion letters – as well as non-public – *e.g.*, designing transactions, drafting press releases and prospectuses, and producing non-public opinions for issuers and underwriters.

Secondary actors have long been regarded as a critical check on fraud by corporations. Executives may face overwhelming temptation to inflate corporate profits through fraud, especially if their compensation is largely equity-based. *See, e.g.*, Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation*, 35 Wake Forest L. Rev. 123, 132-34 (2000) (during the 1990s, compensation of both CEOs and directors became more dependent on stock price). Secondary actors, however, have less motive to participate in fraud. A prominent accounting firm, law firm, or investment bank logically should not sacrifice the reputational capital on which it trades for the fees associated with a single engagement. Thus, requiring secondary actors to approve corporate statements and to facilitate transactions ought to minimize fraud, because these actors are easier to deter than management. *See, e.g.*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [Ernst & Whinney] would suffer from a perception that it would muffle a client's fraud. . . . E & W's partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with Continental."); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) ("[I]t seems extremely unlikely that Coopers & Lybrand was willing to put its professional reputation on the line by conducting fraudulent accounting work for URCARCO."). *See generally* Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53 (1986).

B. Explaining Gatekeeper Failure

The business scandals of recent years, however, revealed that reputational incentives were frequently inadequate to deter secondary actors from participating in fraud. *See, e.g.*, John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Inde-*

pendence and the Governance of Accounting 2-5 (Columbia Law School, The Center for Law and Economics Studies, Working Paper No 191, May 21, 2001), *available at* http://papers.ssrn.com/id=270944; Hillary A. Sale, *Banks: The Forgotten Partners in Fraud*, 73 U. Cin. L. Rev. 139, 140-41 (2004). The failure of professional gatekeepers was reflected not only in a few high-profile cases, but also in a decline in the overall quality of financial reporting. Ten percent of publicly listed companies restated their earnings because of accounting irregularities between 1997 and 2001.[3] Restatements continued to rise between 2002 and 2005.[4] These restatements were not technical; the stock prices of restating companies between 1997 and 2001 suffered immediate, market-adjusted declines of more than 10%. *See* 2002 GAO Report at 24-25; *see also* 2006 GAO Report at 23-24 (market capitalization of restating companies between 2002 and 2005 decreased an estimated $36 billion in the days surrounding a restatement, adjusted for overall market movements).

One explanation of gatekeeper failure is that the potential profits to secondary actors that committed fraud were greater than recognized in cases like *DiLeo* and *Melder*. For example, accountants' incentive to acquiesce in clients' demands was not just their audit fees, but also their desire to retain consulting revenue from audit clients that could easily threaten to take their consulting business elsewhere. *See, e.g.*, Coffee, 57 Bus. Law. at 1410-11

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[3] *See* United States General Accounting Office, Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* 15 (Oct. 2002) ("2002 GAO Report"), *available at* http://www.gao.gov/new.items/d03138.pdf.

[4] *See* United States Government Accountability Office, Report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities* 11 (July 2006) ("2006 GAO Report") (finding a five-fold increase in the number of restatements between 1997 and 2005), *available at* http://www.gao.gov/new.items/d06678.pdf.

& n.36 ("Consulting fees paid by audit clients exploded during the 1990s."); *see also* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 Nw. U. L. Rev. 133, 186-217 (2000) (identifying a host of reasons why it may be economically rational for individual auditors and auditing firms to participate in fraud).[5] Moreover, the advent of new limited liability corporate forms reduced the incentives of partners to monitor one another, decreasing the predictive value of focusing on the reputation of a firm as a whole. *See* Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 Vill. L. Rev. 1167, 1170-72, 1186 (2003).

Like accounting firms, many investment banks also profited from client business at the same time that they allegedly neglected due diligence obligations with respect to clients' other transactions. For example, Citigroup and Salomon Smith Barney allegedly serviced more than $3 billion in loans to a partnership owned by the family that controlled Adelphia, while leading public offerings of Adelphia stock. *See* Deborah Solomon, *Salomon Draws Focus by SEC Over Adelphia*, Wall St. J., June 5, 2002, at C1. With respect to Enron, bank executives allegedly invested their own funds in off-balance-sheet special-purpose entities, while designing and profiting from sham transactions that were intended to let Enron book revenue when it was actually incurring debt. *See In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 637-56, 695-704 (S.D. Tex. 2002); Charles Gasparino & Tom Hamburger, *Congress Broadens Probe of Enron Fall and Wall Street Role*, Wall St. J., Mar. 7, 2002, at C1. Financial institutions' practice of making loans in exchange for underwriting and other fees may be on the rise. *See, e.g.*, Jathon Sapsford, *Executives See Rise in 'Tying' Loans to Other Fees*, Wall St. J., June 9, 2004, at A1; *see also* Frank Part-

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[5] Congress addressed this problem in the Sarbanes-Oxley Act of 2002. *See infra* p. 9.

noy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 Wash. U. L.Q. 491, 524-25 (2001) ("[A]bundant anecdotal evidence suggests that investment banks engage in potentially reputation-depleting activities in order to maximize profits. . . . Substantial agency costs at investment banks prevent managers from restraining lower-level employees who have incentives to deplete the firm's reputation to increase their own profits.").

An increase in available profits, however, is not the only explanation for participation in fraud by secondary actors during the 1990s and early 2000s. As Professor Coffee has observed, those years also saw a marked decrease in the risk of liability for such actors because of decisions by the Court and Congress. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 318-21 (2004) (explaining that *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), shortened the statute of limitations applicable to securities fraud, while *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), eliminated a private right of action for aiding and abetting). In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA") and, in 1998, the Securities Litigation Uniform Standards Act ("SLUSA"). PSLRA imposed a heightened pleading standard in securities fraud class actions, *see* § 101, 109 Stat. 737-49; replaced joint and several liability with proportionate liability, *see* § 201(a), 109 Stat. 758-62; eliminated securities fraud as a predicate for RICO claims for which plaintiffs could seek treble damages, *see* § 107, 109 Stat. 758; and created a safe harbor for forward-looking statements, *see* § 102, 109 Stat. 749-56. SLUSA required class actions alleging securities fraud to proceed in federal court under the PSLRA, rather than in state court. These developments combined to reduce the risk that secondary actors that participated in fraud would be held liable by investors. *See infra* pp. 16-18 (describing

the decline in securities litigation against secondary actors following the legal developments of the 1990s).

C. The Need for Adequate Deterrence

Thus, a central lesson of recent financial scandals is that the cost-benefit analysis for secondary actors tipped too far in the direction of encouraging fraud. Congress took steps to address the benefit side of this equation when it enacted the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley attempted to eliminate problematic incentives for some secondary actors by, for example, barring accountants from providing certain consulting services to audit clients, *see* 15 U.S.C. § 78j-1(g). Congress, however, did not address other categories of secondary actors, such as investment bankers. *See* Sale, 73 U. Cin. L. Rev. at 141 (Sarbanes-Oxley "ignores one key set of gatekeepers – bankers"); *see also* Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 Vill. L. Rev. 1097, 1101 (2003) (Sarbanes-Oxley's reporting-up obligation for lawyers "is unlikely to be an effective response to the types of problems experienced at Enron").

Moreover, Sarbanes-Oxley did not focus on the cost side of the decision-making calculus for secondary actors by strengthening deterrents against fraud. *See, e.g.*, Assaf Hamdani, *Gatekeeper Liability*, 77 S. Cal. L. Rev. 53, 55 (2003) ("despite the apparent consensus that insufficient deterrence of gatekeepers (such as accountants) is to blame for debacles like Enron, there has been virtually no attempt to go down the simple path of making gatekeeper liability more stringent") (footnote omitted); Coffee, 84 B.U. L. Rev. at 337 (though Sarbanes-Oxley reduced expected benefits from participation in fraud, expected costs remain reduced as well). In the wake of Enron and other scandals, commentators have suggested various methods of achieving more adequate deterrence of gatekeepers, for example, a regime of stricter liability. *See, e.g.*, Partnoy, 79 Wash. U. L.Q. at 546-47 (proposing modified strict liability for gatekeepers based on material misstatements

or omissions in offering documents; explaining that, under this proposal, investors who prevail against an issuer for securities fraud would automatically win damages against the relevant gatekeepers, with the only liability limitations being those placed through indemnification or insurance agreements). Whether strict liability, negligence-based liability, or knowledge-based liability for gatekeepers is appropriate may depend on judgments about how effectively gatekeepers can prevent wrongdoing. Where the costs of prevention are unknown or large, a knowledge-based liability standard may be a safe approach. It prevents at least some wrongdoing at low cost, and it allows the costs of gatekeeper compliance to be borne by clients that gatekeepers know to be wrongdoers. *See* Hamdani, 77 S. Cal. L. Rev. at 104.

Without taking a position on what standard of liability best serves public policy, it would certainly undermine the goal of adequate deterrence to eliminate even *knowledge*-based liability for fraud – the *laxest* standard for gatekeepers – simply because no fraudulent statement is publicly attributed to a secondary actor. Secondary actors already confront significant incentives to participate in fraud, as the profits allegedly derived by the investment bank defendants in the Enron litigation illustrate. Allowing such actors to insulate themselves against legal liability simply by avoiding a public announcement of involvement would create overwhelming temptation to enable fraud. Even otherwise well-intentioned secondary actors might acquiesce in a client's demands to consummate a fraudulent transaction or to issue a fraudulent statement in such circumstances. *See, e.g.*, Testimony of Thomas Donaldson, Mark O. Winkelman Professor, The Wharton School, University of Pennsylvania, *Penalties for White Collar Crime: Are We Really Getting Tough on Crime?*, Before the S. Comm. on the Judiciary, 107th Cong. (July 10, 2002) ("Corporate Watergates typically involve scores and sometimes hundreds of people inside the corporation, and all too often, scores of people outside the corporation, i.e., in institutions such as accounting firms, investment

banks, and law firms. The plain truth is that many of these thousands of people are not slime balls or bad apples but ordinary people under extraordinary pressures."), *available at* http://judiciary.senate.gov/testimony.cfm?id=310&wit_id=712.

II. THE STRICT TEST FOR PRIMARY LIABILITY WOULD CREATE A SAFE HARBOR FOR FRAUD

Both real and hypothetical examples illustrate that the strict test, under which a defendant is not a primary violator unless it signs a false statement or owes a fiduciary duty to investors, permits secondary actors to escape liability for clear fraud. At common law, participation in fraud was enough to impose joint and several liability; there was no requirement that the defendant be in privity with the victim or personally speak the misrepresentation to the victim. *See, e.g.*, 37 C.J.S. *Fraud* § 61, at 346 (1943); Restatement (Second) of Torts § 531, at 66 (1977); *see also* Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. Rev. 691, 751-52 (1997) (collecting cases); *Stewart v. Wyoming Cattle Ranche Co.*, 128 U.S. 383, 388 (1888) ("[t]he gist of the action is fraudulently producing a false impression upon the mind of the other party; and, if this result is accomplished, it is unimportant whether the means of accomplishing it are words or acts of the defendant"). Commentators have observed that fraud, by its very nature, may involve hiding the true author of a mistatement. *See, e.g.*, Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 Del. J. Corp. L. 865, 889 (1995) ("The very nature of securities fraud often involves obscuring the source and interests of its authors. People can have a significant influence on how fraudulent disclosure is packaged, and hence how effective it is, without being identifiable to the victim.").

Nevertheless, under the strict test for primary liability, a secondary actor that creates and disseminates a fraudu-

lent statement, but is not publicly identified as the author of the statement, will avoid liability for fraud. It is uncontroversial that an accountant who knowingly issues a false audit opinion under his or her own name may be liable as a primary violator. *See, e.g.*, Dan Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Calif. L. Rev. 80, 107-08 (1981) (cited in *Central Bank*, 511 U.S. at 191). Yet, under the strict test, an accounting firm that designs a transaction so that a client can report it in a misleading manner, prepares a false statement regarding the transaction, and approves release of the statement will *not* be liable as a primary violator if the statement is issued to the public under the client's name, rather than the accounting firm's name.

Similarly, a law firm that creates a fraudulent disclosure for its client, using its expertise to craft the disclosure in a manner that evades unwanted attention, would not be liable. *See, e.g., Ziemba*, 256 F.3d at 1205-06 (allegations that law firm created fraudulent letters and press releases for issuance under client's name did not state a § 10(b) claim); *Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods. N.V.*, No. Civ. A. 00-5965, 2005 WL 3658006, at *11 (D.N.J. June 7, 2005) (preparation of financial statements could not give rise to primary liability where statements were not publicly attributed to defendant at time of plaintiffs' investment decisions); *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558, 1563-64 (1993) (lawyers' preparation of fraudulent SEC filings, press releases, and letters to shareholders, as well as their making false statements to members of the public could not give rise to primary liability in the absence of any fiduciary duty owed to plaintiff shareholders), *modified on other grounds on recon.*, 894 F. Supp. 437 (S.D. Fla. 1995). Even if a secondary actor knowingly circulates false statements to investors, inducing investors to rely on those statements, it will escape liability under the strict test if the statements are under its client's name. *See, e.g., Winkler v. NRD Mining, Ltd.*, 198 F.R.D. 355, 364-66 (E.D.N.Y. 2000) (director and public relations firm could

not be liable for drafting and disseminating releases containing false statements that were not attributed to them).

Courts that reject the strict test have similarly recognized that it would prevent them from holding liable defendants who author false statements that they know will reach investors. *See, e.g., In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 168 (D. Mass. 2002) ("Absolving an auditor who prepares, edits, and drafts a fraudulent financial statement knowing it will be publicly disseminated simply because an affiliated auditor with which it is working under a common trademark is the one to actually sign it, would stretch *Central Bank*'s holding too far."); *Carley Capital Group v. Deloitte & Touche, LLP*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) ("Under the Second Circuit standard, a secondary actor who is the actual creator and author of a material misstatement could avoid liability simply due to the concealment of its identity."); *Employers Ins. of Wausau v. Musick, Peeler, & Garrett*, 871 F. Supp. 381, 389-90 (1994) (rejecting rigid rule that accountant must certify or be named in a document to be liable for misstatements; allowing § 10(b) claim to proceed where accountants were allegedly architects of misleading prospectus), *amended on other grounds on recon.*, 948 F. Supp. 942 (S.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) ("While the investing public may not be able to reasonably attribute the additional misstatements and omissions to [Ernst & Young], the securities market still relied on those public statements and anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5.").

The strict test would also create the perverse result that, if the author of a fraudulent statement knew it was false, but the entity under whose name the statement issued did not, no actor would be liable as a primary violator under § 10(b). For example, courts have held, both before and after *Central Bank*, that a corporation that knowingly reviews and approves false statements in an

analyst's report may be liable as a primary violator of § 10(b). Yet, under the strict test, the corporation could not be liable for statements that were publicly attributed to the analyst. *See In re ICN/Viratek Sec. Litig.*, No. 87 Civ. 4296, 1996 WL 164732, at *5, *7 (S.D.N.Y. Apr. 9, 1996) (explaining that, under the strict rule adopted by some courts, "no matter how extensive a corporation's review and approval of statements in an analyst's report, that review and approval does not imply that the corporation, in effect, has 'made' the statements in the analyst's report, for the purposes of liability under § 10(b)"; rejecting that rule where it would immunize the defendant from § 10(b) liability for reviewing and editing a report that it knew contained false statements about defendants' AIDS drug).[6]

In sum, applying the strict test, a secondary actor can escape liability for creating a fraudulent statement that it disseminates to investors, or knows will be disseminated to the market, so long as it does not announce its authorship of the statement. Such a test rewards obfuscation rather than disclosure, contrary to the aims of the securities laws. Allowing accountants, law firms, investment banks, and other secondary actors to avoid § 10(b) liability so long as misstatements do not issue under their names would enable secondary actors to profit from frauds that they mastermind while concealing their participation from the investing public. That danger is hardly hypothetical, as the evidence and allegations in the Enron litigation demonstrate. Without taking a position on the precise standard for primary liability under § 10(b), the Council respectfully suggests that the strict test would

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[6] While plaintiffs might also try to sue on an agency theory, *cf. Copland v. Grumet*, 88 F. Supp. 2d 326, 333 (D.N.J. 1999) (suggesting that, when a defendant controls the content of another actor's statement, the actor is operating as the agent of defendant), some courts have questioned the scope of agency liability under § 10(b), *see, e.g., In re Lernout & Hauspie*, 230 F. Supp. 2d at 172 (collecting cases). Moreover, if a corporation makes an ultimate decision to issue a statement under its name, it may not be the "agent" of a secondary actor.

undermine incentives for secondary actors to maintain the integrity of the securities markets.

III. FEARS OF OPENING THE FLOODGATES TO FRIVOLOUS LITIGATION ARE UNFOUNDED

Some lower courts adopting the strict test have done so partly out of concern that any other standard would open the floodgates to meritless litigation against secondary actors. For example, the Fifth Circuit admitted that its decision in the Enron litigation allowed secondary actors to "escape liability for alleged conduct that was hardly praiseworthy," but concluded that "the rule of liability must be either overinclusive or underinclusive so as to avoid what *Hundahl* called '*in terrorem* settlements' resulting from the expense and difficulty of, even meritoriously, defending this kind of litigation." *Credit Suisse*, 482 F.3d at 392 (quoting *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1363 (N.D. Tex. 1979)); *see also id.* at 393 (ascribing "a limited interpretation to the words of § 10, viewing the statute as the result of Congress's balancing of competing desires to provide for some remedy for securities fraud without opening the floodgates for nearly unlimited and frequently unpredictable liability for secondary actors"). *Hundahl* was a 1979 decision expressing worries about "strike" suits brought solely for their settlement value. 465 F. Supp. at 1363 & n.8. Similarly, *Central Bank* itself, while focusing on the text of the statute, observed that private securities litigation "'presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general,'" requiring "secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." 511 U.S. at 189 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). The Court suggested that these litigation and settlement costs might ultimately be passed on to investors. *See id.*

A. The PSLRA Has Reduced Frivolous Litigation Against Secondary Actors

Whether or not these fears were well-grounded at the time of *Hundahl* and *Central Bank*, *see* Joel Seligman, *The Implications of Central Bank*, 49 Bus. Law. 1429, 1433-34 (1994) (arguing that *Central Bank*'s summary of policy arguments, which "relied on a single Senator's uncorroborated assertion of litigation costs and fewer than five printed pages on point in an article by Judge Winter," was "based on a mischaracterization of available evidence"), they are far less relevant today. Congress responded to exactly such concerns about "strike suits" in the PSLRA, aiming to reduce the settlement value of meritless lawsuits by permitting dismissal before costly discovery. *See* H.R. Conf. Rep. No. 104-369, at 39 & n.17, *reprinted in* 1995 U.S.C.C.A.N. 738; S. Rep. No. 104-98, at 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693. The pre-trial dismissal rate for securities class actions has nearly doubled since enactment of the PSLRA, while settlement sizes have increased, reflecting a higher proportion of meritorious litigation.[7] Indeed, the PSLRA's heightened pleading standard may have screened out meritorious cases in addition to frivolous ones.[8]

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[7] *See, e.g.*, Todd Foster *et al.*, NERA, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar* 4-5 (Jan. 2007), *available at* http://www.nera.com/image/BRO_Recent%20Trends_%201288_FINAL-web.pdf; Marilyn F. Johnson *et al.*, *Do The Merits Matter More? The Impact of the Private Securities Litigation Reform Act* (Univ. of Mich., John M. Olin Center for Law & Economics, Working Paper No. 02-011, 2006), *available at* http://ssrn.com/abstract=883684.

[8] *See, e.g.*, Stephen Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. Econ. & Org. (forthcoming 2007) (Am. Law & Econ. Ass'n, Am. Law & Econ. Ass'n 15th Annual Meeting, Working Paper 25, 2005), *available at* http://law.bepress.com/alea/15th/art25; Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 Ariz. L. Rev. 711, 714-15 (1996).

The PSLRA's requirement that plaintiffs plead facts giving rise to a "strong inference" of scienter is especially significant for secondary actors. While there may be facts in the public domain enabling plaintiffs to plead scienter with respect to corporate executives – *e.g.*, insider stock sales prior to the public disclosure of negative information – it will be more difficult for plaintiffs to obtain, without discovery, facts indicating intent to commit fraud on the part of secondary actors. *See, e.g.*, Coffee, 57 Bus. Law. at 1410 n.35. Another PSLRA reform with particular impact on secondary actors is the statute's substitution of proportionate for joint and several liability in certain cases. Congress was concerned about the pursuit of "deep pockets" by plaintiffs' lawyers, as well as the unfairness of imposing traditional joint liability on a secondary defendant that might be minimally culpable. *See* H.R. Conf. Rep. No. 104-369, at 37 ("Under current law, a single defendant who has been found to be 1% liable may be forced to pay 100% of the damages in the case."), *reprinted in* 1995 U.S.C.C.A.N. 736; *accord* S. Rep. No. 104-98, at 20, *reprinted in* 1995 U.S.C.C.A.N. 699. The PSLRA thus provided that a defendant would be jointly and severally liable only if the trier of fact "specifically determines that such covered person knowingly committed a violation of the securities laws." 15 U.S.C. § 78u-4(f)(2)(A). When the scienter of a secondary actor is based on recklessness, the actor will "be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that [actor]." *Id.* § 78u-4(f)(2)(B)(i). Finally, SLUSA eliminated plaintiffs' ability to avoid *Central Bank*'s prohibition on private suits for aiding and abetting – as well as the PSLRA pleading requirements – by pursuing class actions against secondary defendants under state law.

These shifts in the legal landscape have to a substantial extent protected secondary actors from liability. An SEC study of the PSLRA's impact found a decline in lawsuits against secondary defendants. *See* Office of the General Counsel, SEC, *Report to the President and the Congress on the First Year of Practice under the Private Securities*

Litigation Reform Act of 1995 (Apr. 1997) (concluding that "[s]econdary defendants, such as accountants and lawyers, are being named much less frequently in securities class actions"), *available at* http://www.sec.gov/news/studies/lreform.txt. More recent studies have confirmed that auditors and underwriters are named defendants in a very small percentage of securities class actions. *See* Cornerstone Research, *Securities Class Action Case Filings, 2006: A Year in Review* 20 (2007) (auditors and underwriters were named in 1% and 5% of cases respectively in 2006), *available at* http://www.cornerstone.com/securities/pdfs/YIR2006.pdf; Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review* 16 (2006) (auditors and underwriters were named in 3% and 4% of cases respectively in 2005, and in 4% and 1% of cases respectively in 2004), *available at* http://www.cornerstone.com/securities/pdfs/YIR2005.pdf; *see also* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1550 (2006) ("Because the majority of securities class actions contain at least some allegations of accounting fraud, this striking omission of auditors and other secondary actors as defendants suggests that they have been well insulated against securities fraud liability.") (footnote omitted).

Thus, the Court should not rely on any pre-PSLRA concerns regarding the need for a strict test to protect innocent secondary defendants. On the contrary, the Court should be hesitant to further immunize secondary actors that are already well-protected from liability by the PSLRA and the SLUSA. *Cf.* Coffee, *The Acquiescent Gatekeeper* at 4-5 (accounting irregularities predictably increase as litigation risks diminish).

B. Allegations of Primary Violations by Secondary Actors Are Not Presumptive Efforts To Evade *Central Bank*

Nor are lawsuits alleging primary violations by secondary actors a recent innovation that might be regarded as

a harbinger of frivolous litigation or an attempt to evade *Central Bank*. *Cf. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1511 (2006) (noting Congress's finding that state-law securities fraud suits were rare before the PSLRA, and that their proliferation reflected an effort to evade the PSLRA). *Central Bank* itself recognized that "[i]n any complex securities fraud ... there are likely to be multiple violators." 511 U.S. at 191. Moreover, prior to the acceptance of aiding-and-abetting liability in the courts of appeals, secondary actors were frequently held liable as primary violators for passing on clients' communications that they knew were false, playing integral roles in fraudulent misstatements, and participating in fraudulent schemes. *See* Prentice, 75 N.C. L. Rev. at 703-04 & nn.52-57 (collecting pre-1969 cases). Later, courts often held that theories of primary liability and aiding-and-abetting liability covered the same conduct by secondary actors. *See id.* at 704-09 & nn.58-60; *see also, e.g., Molecular Tech. Corp. v. Valentine*, 925 F.2d 910, 917-18 (6th Cir. 1991) (attorney's participation in preparing false statements could be primary and secondary wrongdoing); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 978 (1988) (because the complaint adequately pled primary liability, "[i]t follows that the complaint adequately pleads aiding and abetting"), *vacated in part on other grounds on recon.*, 714 F. Supp. 1285 (E.D.N.Y. 1989). Thus, adoption of something other than the strict test would not lead to unprecedented expansion of liability for secondary actors.

C. Plaintiffs Must Still Prove Reliance

A final check on securities litigation against secondary actors is the requirement that plaintiffs prove reliance on a defendant's misstatement or deceptive act. *See, e.g., In re Enron*, 235 F. Supp. 2d at 588-91 (adopting SEC's proposed test, under which a secondary actor that acts with scienter and creates a misrepresentation may be liable as a primary violator, while emphasizing that plaintiffs must still prove reliance). The Council does not take a position on the precise definition of reliance the Court should

adopt. *Cf.* Brief of the SEC, *Amicus Curiae*, in Support of Positions that Favor Appellant at 21, *Simpson v. Homestore.com, Inc.*, No. 04-55665 (9th Cir. filed Oct. 21, 2004) (arguing that reliance exists when "a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction"). However, under the strict test, the elements of a primary violation are not met even when the defendant creates a misstatement and circulates it to investors who rely on it, simply because the misstatement is not attributed to the defendant. The requirement that plaintiffs rely on a fraudulent misrepresentation – as opposed to relying on attribution of the misrepresentation to a particular defendant – does not mandate such a result.

IV. ELIMINATION OF PRIVATE LAWSUITS AGAINST SECONDARY ACTORS WILL RESULT IN INADEQUATE COMPENSATION FOR INVESTORS

Preventing investors from suing secondary actors that commit fraud will result in both inadequate deterrence and inadequate compensation. Investors frequently cannot obtain fraud damages from issuer firms, which may be insolvent or distressed. *See, e.g.*, Cornerstone Research, *Securities Class Action Settlements: 2006 Review and Analysis* 14 (2007) ("[o]ver 35% of the issuer firms in our sample filed for bankruptcy or had their stock delisted from a major exchange before the class action settlement hearing date"; fact that defendant firm is distressed is associated with a decrease in settlement size), *available at* http://securities.cornerstone.com/pdfs/settlements_2006.pdf; Cornerstone Research, *Post-Reform Act Securities Settlements: 2005 Review and Analysis* 14 (2006) ("Cornerstone, *2005 Review and Analysis*") (30% of issuers sued filed for bankruptcy or had their stock delisted), *available at* http://securities.cornerstone.com/pdfs/settlements_2005.pdf. The list of frauds following which investors were able to recover nothing from issuers, with the bulk of

any compensation – usually pennies on the dollar – necessarily coming from secondary actors, is long. It includes, among others, Enron,[9] Global Crossing,[10] Adelphia,[11] Delphi,[12] Refco,[13] and Sunbeam.[14]

Moreover, as both Congress and the SEC have repeatedly recognized, SEC enforcement is not sufficient to deter wrongdoers and to compensate investors. *See, e.g.*, H.R. Conf. Rep. No. 104-369, at 31 (private litigation is "an indispensable tool with which defrauded investors can recover their losses" and is crucial "to the integrity of American capital markets"), *reprinted in* 1995 U.S.C.C.A.N. 730. The SEC does not possess the resources to prosecute most instances of securities fraud. *See, e.g.*, Prepared Testimony of Arthur Levitt, SEC Chairman, and Isaac C. Hunt, SEC Commissioner, *The Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. (Oct. 29, 1997) ("Private actions are an especially important supplement to the Commission's enforcement program today because of the phenomenal growth of the securities industry during a time when the Commission's staff and budget levels have remained relatively constant."), *available at* http://banking.senate.gov/

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[9] *See* Bill Hensel, Jr., *Settlement adds $2.4 billion to the kitty*, Houston Chron., Aug. 3, 2005, *available at* http://www.chron.com/disp/story.mpl/special/enron/3293828.html.

[10] *See* Gretchen Morgenson, *Global Crossing Settles Suit on Losses*, N.Y. Times, Mar. 20, 2004, at C1.

[11] *See Deloitte and Banks to Pay $455 Million to Adelphia Investors*, N.Y. Times, Dec. 9, 2006, at C4; Geraldine Fabrikant, *Rigas Family To Cede Assets To Adelphia*, N.Y. Times, Apr. 26, 2005, at C1.

[12] *See* Nick Bunkley, *S.E.C. Sues Ex-Officials Of Delphi*, N.Y. Times, Oct. 31, 2006, at C1.

[13] *See* Michael J. de la Merced, *Finance Chief Of Refco Is Indicted*, N.Y. Times, Oct. 25, 2006 at C3; *Austrian Bank To Pay Millions In Refco Case*, N.Y. Times, June 6, 2006, at C3.

[14] *See* 2002 GAO Report at 204-06.

97_10hrg/102997/witness/sec.htm; Testimony of Richard C. Breeden, SEC Chairman, *Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 15-16 (Oct. 2, 1991) (SEC is able to prosecute only a fraction of the cases in which investors have suffered losses).[15]

Even when the SEC brings an enforcement action, it often recovers only a fraction of what private lawsuits yield for investors. *See* Cornerstone, *2005 Review and Analysis* at 13, Fig. 12. For example, in the WorldCom litigation, the SEC obtained $750 million for investors, while the related class action obtained $6.2 billion, *see id.*; in the Cendant litigation, the SEC failed to recover any significant amount for investors, while private suits recovered $3.2 billion, *see In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001).[16]

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[15] *See also* Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 Vill. L. Rev. 1139, 1161 (2003) ("Unless there is a vastly enlarged SEC, private actions inevitably must serve as an enforcement substitute for deterrence purposes, as well as their more traditional role as an avenue for appropriate compensation of victims."); Report of the SEC: Section 703 of the Sarbanes-Oxley Act of 2002 – Study and Report on Violations by Securities Professionals 5 (Jan. 2003) (SEC brought only 13 aiding-and-abetting actions against securities professionals in calendar years 1998 through 2001), *available at* http://www.sec.gov/news/studies/sox703report.pdf.

[16] Nor is the ability to file an individual state-law action against a secondary actor, which would not be preempted by SLUSA, an adequate substitute for the ability to file a class action under federal or state law. Even institutional investors often do not have enough at stake with respect to a particular issuer to warrant the expense of an individual lawsuit. Moreover, for many ordinary shareowners, the denial of class relief would mean no relief at all. As the Court has recognized, "'[t]he policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights.'" *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 617 (1997) (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997)).

CONCLUSION

For the foregoing reasons, the Court should not adopt the strict test for primary liability based on policy considerations. Such a test would provide a safe harbor to secondary actors who manage to commit fraud without announcing their involvement to the public. It would not only deny compensation to defrauded investors, but also undermine ongoing efforts, in the aftermath of devastating financial scandals, to strengthen the role of secondary actors in maintaining the integrity of the securities markets.

Respectfully submitted,

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS LLC,
Petitioners,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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BRIEF FOR PROFESSORS JAMES D. COX, JILL E. FISCH, DONALD C. LANGEVOORT, RICHARD M. BUXBAUM, MELVIN A. EISENBERG AND HILLARY A. SALE AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Whether a person who actively engages in a sham transaction with the purpose and effect of causing a publicly traded company to make a materially false or misleading statement of its financial condition has used or employed a deceptive device or contrivance within the meaning of §10(b) and has thereby committed a primary violation of the statute.

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IN THE

Supreme Court of the United States

No. 06-43

STONERIDGE INVESTMENT PARTNERS LLC,
Petitioners,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR PROFESSORS JAMES D. COX, JILL E. FISCH, DONALD C. LANGEVOORT, RICHARD M. BUXBAUM, MELVIN A. EISENBERG AND HILLARY A. SALE AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

INTEREST OF *AMICI CURIAE* [1]

Amici are law professors who study, analyze and teach the federal securities laws and their role in regulating U.S. capital

[1] Counsel for respondents and for petitioners have consented to the filing of this amicus brief. This brief was not authored, in whole or in part, by counsel for either party. Sanford Svetcov and Susan Alexander of the Lerach Coughlin firm—other members of which are counsel of record for The Regents of the University of California ("The Regents"), petitioners in *Regents v. Merrill Lynch*, No. 06-1341, presenting the same issue as is raised here, and counsel for The Regents in submitting a separate *amicus* in this case—have provided substantial assistance in the preparation and submission of this *amicus* brief. The Lerach Coughlin firm paid for the printing of the brief.

markets. A brief summary of their individual and collective experience follows:

1. Professor James D. Cox joined the faculty of the School of Law at Duke University in 1979 where he specializes in corporate and securities law. Previously, he taught at the law schools of Boston University, the University of San Francisco, Stanford University and at Hastings College of the Law. Professor Cox earned his law degree at the University of California, Hastings College of the Law (J.D.) and Harvard Law School (LL. M.). In addition to his texts *Financial Information, Accounting and the Law*; *Cox and Hazen on Corporations*; and *Securities Regulations Cases and Materials* (with Professors Hillman & Langevoort), Professor Cox has published extensively in the areas of market regulation and corporate governance as well as having testified before the U.S. House and Senate on insider trading and market reform issues. He is a former member of the New York Stock Exchange ("NYSE") Legal Advisory Committee and a member of the National Association of Securities Dealers ("NASD") Legal Advisory Board.

2. Professor Jill E. Fisch is a Visiting Professor at the University of Pennsylvania Law School and T.J. Maloney Professor of Business Law at Fordham University. In 1989, after obtaining her J.D. from Yale Law School, and two years with the Justice Department and the Cleary Gottlieb firm, respectively, Professor Fisch joined the Fordham faculty where she serves as Director of the Fordham Corporate Law Center. Professor Fisch teaches corporations, securities regulation and federal courts. She is chair-elect of the Section on Securities Regulation and a former chair of the Section on Business Associations of the Association of American Law Schools. Professor Fisch's scholarship includes work on corporate law, securities regulation, and federal courts, that have appeared in a variety of publications including the Harvard, Columbia and Cornell Law Reviews, and the Yale

Law Journal. (*E.g.*, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 Colum. L. Rev. 650 (2002).

3. Professor Donald C. Langevoort is Thomas Aquinas Reynolds Professor of Law at Georgetown Law Center. He received a J.D. from Harvard. Prior to joining the Law Center faculty in 1999, Professor Langevoort was the Lee S. and Charles A. Speir Professor at Vanderbilt University School of Law, where he joined the faculty in 1981. After practicing for two years at Wilmer, Cutler & Pickering in Washington, D.C., he joined the staff of the U.S. Securities & Exchange Commission ("SEC") as Special Counsel in the Office of the General Counsel. Professor Langevoort is the co-author, with Professors James Cox and Robert Hillman, of *Securities Regulation: Cases and Materials*, and the author of a treatise entitled *Insider Trading: Regulation, Enforcement and Prevention.* Professor Langevoort has testified numerous times before Congressional committees on issues relating to insider trading and securities litigation reform.

4. Professor Richard M. Buxbaum received his law degrees from Cornell Law School (LL.B. 1952) and the University of California, Boalt Hall School of Law (LL.M. 1953). After practicing law for eight years, he joined the Boalt faculty in 1961. He publishes and teaches in the fields of corporate law and comparative and international economic law. Professor Buxbaum has served on various state and national committees engaged in the drafting of securities legislation.

5. Melvin A. Eisenberg is Koret Professor of Law at the University of California, Boalt Hall School of Law. He received his law degree from Harvard in 1959. After practicing with the Kaye Scholer firm in New York, and serving as assistant counsel to the Warren Commission, he joined the Boalt Faculty in 1966. Professor Eisenberg is the author of *The Structure of the Corporation* (1997) and has

published casebooks on the subjects of contracts and corporations. He was chief reporter for the American Law Institute's *Principles of Corporate Governance*.

6. Professor Hillary A. Sale holds the F. Arnold Daum Chair in Corporate Finance and Law at the University of Iowa College of Law, where she joined the faculty in 1997. She is the author of numerous articles on securities and corporate governance issues. Two of her articles, *Delaware's Good Faith* (2004) and *Securities Fraud as Corporate Governance: Reflections Upon Federalism* (2003), were selected by the *Corporate Practice Commentator* as among the "top ten" corporate and securities law articles published in those years. She is co-author of the *Securities Regulation* casebook with John Coffee and Joel Seligman, and is a member of the ABA Committee on Corporate Laws.

The issue in this case is whether a person is liable under §10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)) and SEC Rule 10b-5 (17 C.F.R. §240.10b-5) for actively engaging in sham transactions with the purpose and effect of causing a public company to misrepresent its financial condition, even though the person himself makes no public misstatement. Here, the Eighth Circuit held that absent "a fraudulent misstatement or omission," a person's deceptive acts as part of a scheme to defraud are no more than aiding and abetting for which no private civil liability exists under §10(b) in light of this Court's decision in *Central Bank N.A. v. First Interstate Bank N.A.*, 511 U.S. 164 (1994). *In re Charter Commc'ns. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006).

Amici, who have for many years studied the effect of the federal securities laws on capital markets, are concerned that such a narrow construction of §10(b) could seriously impair the integrity of our securities markets by precluding investor recovery from those responsible for devastating losses caused by fraudulent schemes with multiple actors, only one of whom

makes a public misrepresentation. The Court of Appeals' grudging construction is flatly inconsistent with the plain language of §10(b) and Rule 10b-5, and with *Central Bank* itself. Indeed, *Central Bank* cabins its holding to knowing assistance through lawful conduct, but reaffirms §10(b) liability for "deceptive" as well as "manipulative" acts. 511 U.S. at 178, 191.

As discussed in this brief, *amici* agree that actively engaging in a deceptive scheme of sham transactions requires far more than simply proceeding with a legitimate deal knowing it will assist, *i.e.* aid and abet, others who misrepresent the deal. But when there is far more, as in this case, then unless investors can recover from any person who engages in deceptive sham schemes, the integrity of our markets will suffer. These investors—and the markets—will suffer because centrally and recurrently involved third party schemers will face far weaker disincentives to avoid participating in sham transactions which they know are at the heart of a company's fraudulent misstatements. In some cases, where the company making misstatements is insolvent, such active schemers will be the only source of recovery.

SUMMARY OF ARGUMENT

Section 10(b) makes it "unlawful for any person" to "directly or indirectly" "use or employ" a "deceptive device or contrivance" to cause economic loss "in connection with the purchase or sale of any security." 15 U.S.C. §78j(b). Thus, according to its plain language, §10(b) proscribes deceptive ***conduct*** that purposefully causes a misrepresentation by a public company in connection with the purchase or sale of a security.

For nearly 40 years, this Court has recognized "beyond peradventure" the existence of an implied private right of action for damages for violation of §10(b). *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983). In enact-

ing the Private Securities Litigation Reform Act ("PSLRA") in 1995, with all of its procedural and substantive standards for private suits, Congress effectively made the private right of action explicit: "The provisions of this subsection shall apply in each private action arising under this title that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure." 15 U.S.C. §78u-4(a)(1).

In *Central Bank*, however, this Court barred private suits for aiding and abetting a §10(b) violation. 511 U.S. at 177. *Central Bank* rejected a substantial body of circuit law that had allowed private aiding and abetting actions under §10(b). *Id.* The circuits had long defined aiding and abetting to mean any conduct that knowingly assisted or facilitated another's fraudulent misrepresentations. *Id.* at 170-71. *Central Bank* rejected aiding and abetting liability under §10(b) because it exposed secondary actors to liability based simply on their participation in legitimate transactions, combined with reckless knowledge that a company would misrepresent or misreport those transactions. *Id.* at 168. This Court concluded that such knowledge was insufficient to turn a party engaging in a legitimate deal into a primary violator. *Id.* at 190.

Amici submit that actively engaging (unlawfully) in sham transactions and other deceptive conduct with the purpose and effect of causing misrepresentations involves far more than knowingly assisting through lawful conduct that *Central Bank* released from the reach of §10(b). Actively engaging in sham transactions is deceptive conduct designed to cause a company to make misrepresentations, and is distinct from ordinarily lawful acts of omission or commission that merely aid or assist another's misstatements. Thus, both the deceptive sham transaction and the subsequent misstatement constitute "unlawful" primary violations of §10(b).

Indeed, *Central Bank* itself reaffirmed primary liability for "persons who engage, ***even indirectly***, in a proscribed

activity." 511 U.S. at 176.[2] This Court made clear that in barring aiding and abetting liability it did not redefine "use" of a "deceptive device or contrivance." Rather, *Central Bank* affirmed ***primary*** liability for "***acts*** that are . . . themselves manipulative ***or deceptive*** within the meaning of statute." *Id.*

In so holding, this Court was consistent with its earlier decisions affirming liability for deceptive ***conduct***, as well as for statements and omissions. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972). In *Huddleston*, for example, this Court held that an action under §10(b) "extends to 'any person' who engages in fraud in connection with a purchase or sale of securities" even though they did not themselves make the public misrepresentations contained in the company's registration statement that were separately actionable under §11. 459 U.S. at 387 n.22.

Shortly after *Central Bank*, Congress enacted the PSLRA and defined a knowing "'violation of the securities laws'" to include, in addition to misrepresentations, any conduct that is not a material misstatement or omission. 15 U.S.C. §78u-4(f)(10)(A). Thereafter, this Court emphatically stated that §10(b) does not require a "misrepresentation" by the defendant. *SEC v. Zandford*, 535 U.S. 813, 820 (2002). Recently, in *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 346 (2005), this Court again held that to prove a §10(b) violation, plaintiff must link its loss to "defendant's misrepresentation (***or other fraudulent conduct***)."

The deceptive conduct here is even more egregious than *Zandford*, where only a single investor was harmed, because here respondents conduct was designed and essential to enable direct misstatements by Charter that injured the entire market. Charter is liable under §10(b) for the misstatements. But, respondents who actively engaged in a scheme of de-

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[2] Emphasis is added, and internal citations and footnotes are omitted unless otherwise noted.

ceptive conduct, creating sham paper transactions causing Charter's public misrepresentations, should also be held accountable as primary violators of §10(b).

By implication, the Eighth Circuit appeared to acknowledge that sham transactions designed to cause deceptive statements may be actionable when it observed that §10(b) does not impose liability on a party that "entered into an arm's length non-securities transaction" with another party that uses the transaction to publish false statements. *Charter*, 443 F.3d at 992-93. The Eighth Circuit nevertheless proceeded to err in two discrete ways.

First, it recited but did not credit the allegations in the complaint that the transactions were sham, illegitimate "round-trip" deals with no value other than to falsely inflate Charter's publicly reported revenues: "Plaintiffs alleged that the Vendors entered into these sham transactions knowing that Charter intended to account for them improperly. . . ." *Id.* at 990. The Eighth Circuit overlooked that plaintiffs' complaint alleged that the vendors agreed to unlawful kickbacks and phony advertising fees that were complete shams. (Second Amended Consolidated Class Action Complaint, ¶¶7-11, 91-114). As this Court very recently reaffirmed, "'Rule 12(b)(6) does not countenance . . . dismissals based on a judge's disbelief of a complaint's factual allegations.'" *Bell Atlantic v. Twombley*, __ U.S. __, No. 05-1126, 2007 U.S. LEXIS 5901, at *22 (U.S. May 21, 2007) (quoting *Neitzke v. Williams*, 490 U.S. 319, 327 (1989)).

Second, the Eighth Circuit threw out the baby with the bath water. Ignoring its own apparent distinction between ***arm's length*** and ***sham*** transactions, it held that a §10(b) violation included only a misrepresentation (or omission with a duty to disclose) or a manipulative act (direct manipulation of stock trading). *Charter*, 443 F.3d at 992. The Eighth Circuit's narrow definition of "deceptive" limits it to the "making" of a misrepresentation, and thereby erroneously eliminates en-

tirely any ***conduct*** constituting the use or employment of a "deceptive device or contrivance" even though that language plainly reaches activities that cause a purposeful misrepresentation. The Eighth Circuit's narrow construction of the statute was error under *Affiliated Ute* and *Zandford*, and indeed under a proper reading of *Central Bank*.

ARGUMENT

I. *Central Bank* Bars Aiding and Abetting Liability, but Reaffirms Primary Liability for Actively Engaging in Deceptive Conduct that Causes a Public Company to Misrepresent Its Financial Condition to the Market

Central Bank did not reach—and does not limit—liability of actors who engage in deceptive conduct with the purpose and effect of creating a false appearance of fact regarding the true financial condition of a publicly-traded company. *Central Bank* expressly limited its consideration to those who aid and abet fraud, rather than those who actively engage in it.

The Court itself circumscribed the issue it addressed: "whether private civil liability under §10(b) extends as well to those who ***do not engage*** in the manipulative or deceptive practice." *Central Bank*, 511 U.S. at 167. Indeed, the allegation against Central Bank was based on a failure to act, rather than on any active conduct. *Id.* at 168 ("Central Bank agreed to delay independent review of the appraisal until the end of the year," by which time the public building authority had already defaulted). The Court reported that "Respondents concede that Central Bank did not commit a manipulative or deceptive act within the meaning of §10(b)." *Id.* at 191.

Central Bank explicitly distinguished between actors who do engage—even indirectly—in deceptive conduct and actors who merely aid and abet others. "[A]iding and abetting liability extends beyond ***persons who engage, even indirectly, in a proscribed activity***; aiding and abetting liability

reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* at 176. That distinction is supported by the plain language of §10(b), this Court's subsequent decision in *Zandford*, and the PSLRA.

A. The Plain Language of Section 10(b) Prohibits Indirect As Well As Direct "Use" of a "Deceptive Device or Contrivance"—and Thus Proscribes Sham Transactions that Cause Misrepresentations by a Company in Connection with the Purchase or Sale of a Security

The statutory language is "'[t]he starting point in every case involving construction of a statute. . . .'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). Putting the pertinent language of §10(b) side-by-side with the holding of *Charter* shows that the Eighth Circuit rewrote the plain meaning of the statute as follows:

It shall be unlawful for any person, ***directly or indirectly***, ...	It shall be unlawful for any person, ***directly*** [***but not indirectly***], ...
(b) To ***use or employ***, in connection with the purchase or sale of any security . . . ***any*** manipulative or ***deceptive device or contrivance*** in contravention of such rules and regulations as the [SEC] may prescribe	(b) To ***make or fail to make by one who has a duty to disclose*** [***but not use or employ***], in connection with the purchase or sale of any security . . . ***any manipulative device or contrivance or a deceptive statement*** [***but not any other deceptive device or contrivance***] in contravention of such rules and regulations as the [SEC] may prescribe . . . .

15 U.S.C. §78j(b), *cf*, *Charter*, 443 F.3d at 992 (holding "A device or contrivance is not 'deceptive,' within the meaning of §10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose."). The Eighth Circuit's revisionist construction ignores the statute's plain language, its "commonly accepted meaning," and this Court's reliance on the dictionary to find that the common meaning of "device" and "contrivance" include "a scheme to deceive." *See Hochfelder*, 425 U.S. at 198-99 & n.20.

This Court previously rejected nearly identical logic from the Eighth Circuit in *United States v. O'Hagan*, 521 U.S. 642 (1997). Referencing the sentence from *Central Bank* in which the Court gave a shorthand definition of deceptive conduct which could be construed as limiting such conduct to misstatements or omissions (511 U.S. at 177), this Court clarified that no such limitation was intended:

> The Eighth Circuit isolated the statement just quoted and drew from it the conclusion that §10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely. It is evident from the question presented in *Central Bank*, however, that this Court, in the quoted passage, sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under §10(b) and Rule 10b-5 for ***certain conduct***.

O'Hagan, 521 U.S. at 664.

Without revision, the plain text of the statute makes it "unlawful for any person, . . . indirectly, . . . to use or employ, . . . any . . . deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. §78j(b). As this Court held in *Central Bank*, "the statutory text controls the definition of conduct covered by §10(b)." 511 U.S. at 175. The Eighth Circuit's requirements of statements, omissions and duties simply do not appear in

the text. The plain meaning of the words "any . . . deceptive device or contrivance" necessarily includes conduct.

Following the plain text of the statute, the SEC's long-standing recognition of scheme and conduct liability in Rule 10b-5(a) and (c) is entitled to deference. *Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979). Rule 10b-5 makes it unlawful for "any person, directly or indirectly," "(a) [t]o employ any device, scheme or artifice to defraud" and "(c) [t]o engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. §240.10b-5(a) and (c).

Prior to *Central Bank*, this Court had expressly stated that a defendant violates Rule 10b-5 when it engages in "a 'course of business' or a 'device, scheme, or artifice' that operates as a fraud." *Affiliated Ute*, 406 U.S. at 153. Nothing in *Central Bank* changes that. Indeed, continuing to follow the plain language of the statute, this Court recently held that to prove a violation, plaintiff must "prove that the defendant's misrepresentation (***or other fraudulent conduct***) proximately caused the plaintiff's economic loss." *Dura*, 544 U.S. at 346.

B. This Court's Decision in *Zandford*—Eight Years After *Central Bank*—Affirms Liability for Deceptive *Conduct*, as Well as for Statements and Omissions

In *Zandford*, this Court affirmed that commission of a deceptive act—even one not accompanied by a public misrepresentation—is subject to primary liability under §10(b). *Zandford*, 535 U.S. at 820. Eight years after *Central Bank*, this Court held that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id.* As noted above, the *Charter* case is stronger than *Zandford* because here respondents' deceptive conduct consisted of sham transactions that purposefully caused a public company

to directly misrepresent its financial results and thereby deceive market investors.

Beyond clarifying that deceptive conduct is not limited to statements or omissions, however, the Court's analysis in *Zandford* explains that where the "aggregate" impact of an actors' conduct operates "as a fraud or deceit," those facts support a finding that such conduct is "deceptive" and a basis for primary liability under the Act. 535 U.S. at 820-21. Where fraudulent purpose cannot be separated from the acts themselves, primary liability is appropriate: "The securities sales and respondent's fraudulent practices were not independent events. . . . Rather, respondent's fraud coincided with the sales themselves." *Id.* at 820. Thus, where a sham transaction has the purpose and effect of operating as a fraud or deceit on the market in connection with trading in securities by causing the misrepresentation of the true financial condition of a publicly-traded company, the principals to that transaction have committed "deceptive conduct," actionable as a primary violation of §10(b).

The SEC defines "a deceptive act" similarly: as "'engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues.'" *See Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006). In *Zandford*, this Court held that "[The SEC's] interpretation of the ambiguous text of §10(b), in the context of formal adjudication, is entitled to deference if it is reasonable." *Zandford*, 535 U.S. at 819-20.

As the Ninth Circuit explained, the analysis of whether primary liability lies under §10(b) properly focuses on the defendants' own conduct: "the defendant's ***own conduct*** contributing to the transaction or overall scheme must have had a deceptive purpose and effect." *Simpson*, 452 F.3d at 1048 (emphasis by the court). "The focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only those defendants who use

or employ a manipulative or deceptive device) are held liable under the Act." *Id.* at 1049. "If multiple participants used or employed a deceptive device in furtherance of a scheme to misrepresent the reported revenues of a company, then all participants may be viewed as having acted in connection with the purchase or sale of securities." *Id.* at 1051. The requirement of reliance on the integrity of the market price is satisfied because a misleading public statement is the intended end result of the scheme. *Id.* at 1052.

Focus on a defendant's own conduct is consistent with this Court's direction in *Zandford*, holding that §10(b) "should be 'construed . . . to effectuate its remedial purposes'" (535 U.S. at 819), and in *Central Bank*, holding that what §10(b) "'catches must be fraud.'" 511 U.S. at 174. Thus, a defendant whose own conduct has the purpose and effect of creating deception in connection with the purchase or sale of a security is properly subject to primary liability under §10(b)—whether his own conduct involved a misstatement, an omission, or some other device or contrivance that causes a misrepresentation.[3]

C. The PSLRA—One Year After *Central Bank*—Affirms Congress' Continuing Intention to Prohibit Deceptive *Conduct*

Congress demonstrated its intention to continue to prohibit deceptive conduct as well as deceptive statements and omissions in passing the PSLRA, Pub. L. 104-67, 109 Stat.

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[3] A recent district court decision highlights the risks of such an unduly narrow construction of §10(b). The court held that the principal asset manager of a group of mutual funds whose deceptive conduct was integral to a fraudulent scheme and who even disseminated the fund prospectus containing misstatements was not liable under §10(b) simply because the manager did not make the misstatements to the public that were the product of the scheme. *In re Mut. Funds Inv. Litig.*, __ F. Supp. 2d __, No. JFM-04-818, 2007 U.S. Dist. LEXIS 37923, at *5-*11 (D.Md. May 21, 2007).

737 (1995). In addressing proportionate liability, Congress revised the Securities Exchange Act of 1934 and defined "a covered person" under the Act in two parts. 15 U.S.C. §78u-4(f)(10)(A)(i) and (ii). In part (i), Congress defined requirements for "an action that is based on an untrue statement of material fact or omission of a material fact." *Id.* In part (ii), Congress defined requirements for "an action that is based on any ***conduct*** that is not described in clause (i)." *Id.* Congress clarified that a "covered person" is one who "engages in that ***conduct*** with actual knowledge of the facts and circumstances that make the ***conduct*** of that covered person a violation of the securities laws." *Id.*

The statute must be read "so as to avoid rendering superfluous any parts thereof." *Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 112 (1991). Section (ii) demonstrates Congress' intent to continue to make unlawful not only misstatements and omissions covered by subsection (i) but also ***deceptive*** as well as manipulative ***conduct***. Had Congress wanted to limit "conduct" to manipulative trading practices as the Eighth Circuit did in this case, it could easily have said "manipulative" conduct—but did not. *See Central Bank*, 511 U.S. at 176-77 (If Congress wanted abettor liability, it would have used the words "aid" and "abet."). By broadly using the term "conduct" in the PSLRA, Congress retained deceptive acts as actionable conduct under §10(b).

II. *Central Bank* Rejected Aiding and Abetting Liability Under Section 10(b), Defining Such Conduct as It Had Been Cabined by Prior Circuit Cases to Knowingly Assisting Another's Misrepresentations Through Otherwise Lawful Conduct, Thus Limiting Its Holding to Those "Who Did Not Commit a Manipulative or Deceptive Act"

Aiding and abetting liability under §10(b)—as it existed prior to *Central Bank*—was conditioned on proof of three elements: "(1) the existence of a securities law violation

by the primary party (as opposed to the aiding and abetting party); (2) 'knowledge' of the violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation." *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985). Most circuits followed this standard. *Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983); *Monsen v. Consol. Dressed Beef Co., Inc.*, 579 F.2d 793 (3d Cir. 1978); *Schatz v. Rosenberg*, 943 F.2d 485, 495 (4th Cir. 1991); *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 652 (9th Cir. 1988).

It was in the context of this understanding of aiding and abetting that this Court in *Central Bank* rejected abettor liability and held that §10(b) required more. Indeed, in reaching its decision, this Court acknowledged a similar concern to that expressed by the Seventh Circuit in diverging from the majority of circuits by requiring that the defendant "commit one of the 'manipulative or deceptive' acts prohibited under section 10(b) and rule 10b-5" to be liable for aiding and abetting. *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986); *accord Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990). Citing *Barker*, this Court explained that "the Seventh Circuit has held that the defendant must have committed a manipulative or deceptive act to be liable under §10(b), a requirement that in effect forecloses liability on those who do no more than aid or abet a 10b-5 violation." *Central Bank*, 511 U.S. at 170.

Whereas the Seventh Circuit did not hold that aiders and abettors could not be liable under §10(b), this Court could and did. But, like the Seventh Circuit, this Court's decision in *Central Bank* was based on the concept that "the defendant must have committed a manipulative or deceptive act to be liable under §10(b)" and that those who do not commit such conduct "do no more than aid or abet" another's violation and are not liable. *Central Bank*, 511 U.S. at 170. This Court

required actual commission of a proscribed act rather than mere "substantial assistance" and "knowledge" of another's primary violation. *Id.* at 190.

The critical distinction in *Central Bank* was between conduct—generally legitimate business conduct—that simply assists in the consummation of the transaction that harms the investor, and conduct that is itself at the heart of the fraud. Indeed, this distinction is crucial in separating aiding and abetting conduct from primary violator conduct. In *Central Bank*, this Court emphasized that plaintiffs did not allege that Central Bank of Denver committed "a manipulative or deceptive act," and indeed had conceded there were no such acts. *Id.* at 191. Instead, the plaintiffs alleged that the bank assisted Colorado Springs-Stetson Hills Public Authority's fraudulent promotion of bonds simply by knowingly delaying its appraisal of the property that was security for the loan. *Id.* at 168. In short, *Central Bank* refused to impose §10(b) liability on actors who merely aided and abetted another's fraud by lawful conduct that knowingly assisted in the transaction's consummation, as opposed to committing an unlawful deceptive act themselves. *Compare Peat Marwick*, 857 F.2d at 652 (financial statements certified by accounts were not misleading, but the accountant held to be an aider and abettor because its certification assisted issuer raising funds from investors by touting a technology that the accountants knew was not as represented by the issuer).

As Judge Kaplan explained in *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005), "an aider and abettor is nothing more nor less than someone who deliberately facilitates another's primary violation. *Central Bank* foreclosed liability for aiding and abetting the Rule 10b-5 violations of others, but the decision did not change the scope of Rule 10b-5 or what constitutes a primary violation of it." *Id.* at 493. Actively engaging in a sham transaction with the purpose and effect of causing a material misrepresentation is

a primary violation of §10(b) because the person has used or employed "a deceptive device or contrivance" proscribed by the statute.

CONCLUSION

For the foregoing reasons, the judgment of the Eighth Circuit should be reversed.

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No. 06-43

In the Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC AND MOTOROLA, INC.
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF AMICUS CURIAE FOR DEFENSE RESEARCH INSTITUTE IN SUPPORT OF RESPONDENTS

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF AMICUS CURIAE FOR DEFENSE RESEARCH INSTITUTE IN SUPPORT OF RESPONDENTS

INTEREST OF AMICUS CURIAE[1]

With the consent of the parties, the Defense Research Institute ("DRI") submits this amicus curiae brief in support of respondents.[2] DRI is an international organization that includes more than 22,000 attorneys involved in the defense of civil litigation. DRI is committed to enhancing the skills, effectiveness, and professionalism of defense attorneys. Because of this commitment, DRI seeks to address issues germane to defense attorneys and the civil justice system, to

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[1] Pursuant to Supreme Court Rule 37.6, *amicus curiae* states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than the *amicus curiae*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief.

[2] Letters reflecting written consent of the parties to the submission of this brief have been filed with the Clerk of Court.

promote the role of the defense attorney, and to improve the civil justice system. DRI has long been a voice in the ongoing effort to make the civil justice system more fair, efficient, and — where national issues are involved — consistent.

To promote these objectives, DRI participates as amicus curiae in cases that raise issues of import to its membership and to the judicial system. The expansion of liability to private plaintiffs under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 that petitioner urges in this case poses a distinct threat to the efficient and fair administration of justice. By seeking to impose costly private litigation on secondary parties, petitioner advocates a result that would have multiple deleterious consequences. It would dramatically expand the scope and uncertainty of securities litigation, thus straining the courts. It would create costly new duties for secondary parties to monitor public statements made by others, thus straining the economy. Congress has not created such duties or grounds for liability against secondary parties, and this Court therefore should reject petitioner's contentions.

The important legal issues in this case are, accordingly, of substantial concern to DRI. Since its members have first-hand experience with litigation under Section 10(b), DRI is well-suited to address the pernicious consequences of the liability standard on which petitioner's arguments are based.

SUMMARY OF ARGUMENT

For reasons stated in the respondents' brief, there is no merit to petitioner's effort to expand Section 10(b) and Rule 10b-5 private liability in ways Congress never enacted

and surely never intended. This brief will not replow grounds well presented by respondents. Instead, DRI will provide illustrations of real-world situations — drawn from actual cases — that should inform this Court's assessment of the issues. In addition, DRI will address other statutory provisions that undermine petitioner's contention that there is a need or justification for dramatically enlarging the reach of Section 10(b) to ensnare secondary parties who made no statements and undertook no actions on which investors relied.

1. By definition, the secondary parties that petitioner's theory of liability is intended to reach are outsiders to the company in which plaintiffs are shareholders. These outsiders made no public statements that were false or misleading, nor any statements or actions on which the issuer's shareholders reasonably could have relied. In short, the targets of petitioner's "scheme liability" theory are parties who did not themselves violate Section 10(b) or Rule 10b-5. The question, then, is whether the statute can be read to cover parties who are not within the statutory terms. The analysis and holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), compel the conclusion that Section 10(b) does not reach such secondary actors. Accordingly, the Court should reject petitioner's effort to circumvent the holding of *Central Bank* by relabeling alleged aiders/abettors as "secondary actors" or even "primary actors." Respondents are outsiders to the issuer and their actions did not violate any duty to petitioner imposed by the statute.

The realities of the business and financial world place many companies in this sort of secondary contact with issuers of securities. Vendors, customers, contracting parties, partners, co-venturers, and others are frequently involved in

commercial transactions that are reflected in an issuer's financial statements and public disclosures. But there is no justifiable basis for imposing liability under Section 10(b) on these outsiders based on the public statements and allegedly deceptive acts of the issuer. The outsiders have no control over the issuer's statements, may not even be aware of them, and often do not have access to the underlying information required to ascertain the accuracy of the issuer's statements or their materiality to the issuer's shareholders. Indeed, the outsiders may even be victims targeted by the issuer's scheme. Numerous examples drawn from class-action complaints filed in federal court bear out these descriptions. Under settled law, there is no private claim against these outsiders and, typically, they are not sued. But the expansive notions of liability petitioner espouses would impose on such outsiders an entirely new duty to monitor and report to the public on statements made by issuers with whom they have a business relationship. The costly consequences of such a duty underscore the pernicious nature of the rule petitioner urges.

2. In contrast to the burdens petitioner would impose on outsiders, there is scant potential benefit from the rule of expansive private liability that petitioner advances. In its careful creation of the regulatory regime for securities, Congress provided no private liability for such secondary actors. Instead, Congress conferred circumscribed authority on the Securities and Exchange Commission ("SEC") — but not private plaintiffs — to pursue enforcement remedies against persons who substantially contribute to a violation of Section 10(b). *See* Securities Exchange Act of 1934 § 20(e), 15 U.S.C.A. § 78t(e); Sarbanes-Oxley Act of 2002 § 308(a), 15 U.S.C.A. § 7246(a). There is no warrant for this Court to undo the statutory balance of authority and the circumscribed remedies Congress created, especially where the SEC has

successfully implemented its authority to obtain recovery for investors in situations where the SEC has concluded such a remedy is warranted.

ARGUMENT

I. THERE IS NO STATUTORY BASIS FOR THE IMPRACTICAL BURDENS AND EXPANDED LIABILITY PETITIONER SEEKS TO CREATE

At their core, the arguments petitioner advances for imposing liability on respondents can be seen as a semantic circumvention of this Court's holding in *Central Bank*, 511 U.S. 164 (1994). In that case, the Court observed that § 10(b) "prohibits ... the making of a material misstatement (or omission) or the commission of a manipulation act," but that the statutory prohibition "does not include giving aid to a person who commits a manipulation or deceptive act." *Id.* at 177 (internal citation omitted); *see also United States v. O'Hagan*, 521 U.S. 642, 651 (1997) ("Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition") (citation omitted).

In this fundamental respect, *Central Bank* embodies the Court's longstanding refusal "to allow 10b-5 challenges to conduct not prohibited by the text of the statute." 511 U.S. at 173. Consistent with that rule of fidelity to the statutory language, the Court has rejected prior efforts to extend private Section 10(b) liability beyond the statute's express requirements: (1) negligent acts cannot constitute

violations[3]; (2) breaches of fiduciary duty are not actionable absent misrepresentation or a lack of disclosure[4]; and (3) there can be no violation without a duty to disclose.[5]

Even for primary wrongdoers whose actions violate statutory standards, there is no private liability absent a plaintiff's reliance on the wrongful acts in connection with the purchase or sale of securities. *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988). And, as the Court explained in *Central Bank*, lack of reliance on the statements or actions of each defendant is a principal reason why liability does not extend beyond primary wrongdoers to aiders and abettors. 511 U.S. at 180. The Court has instructed that private secondary liability must fail since it necessarily lacks the proofs expressly required by the text of Section 10(b):

> A plaintiff must show reliance on the defendant's misstatement or omission .... Were we to allow the aiding and abetting action ... the defendant could be liable without any showing that the plaintiff relied upon the aiders and abettor's statements or actions. .... Allowing plaintiffs to circumvent the reliance requirement would disregard ... limits on 10b-5 recovery mandated by our earlier cases. *Id.* at 180

Petitioner in the present case would similarly circumvent the reliance requirement (and the other

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[3] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-98 (1976).

[4] *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 463 (1977).

[5] *Chiarella v. United States*, 445 U.S. 222, 232-34 (1980).

requirements of Section 10(b)) by crafting the term "scheme liability" in an effort to reach the "aiding and abetting" liability rejected in *Central Bank*. It is wholly inconsistent with the holding and rationale of *Central Bank* to re-label alleged conduct that previously would have been viewed as aiding and abetting with a new appellation designed only to create an escape hatch from the rule of *Central Bank*. Equally as important, petitioner offers no principled basis for distinguishing aiding and abetting from the conduct it seeks to make subject to private lawsuits. The absence of such a distinction is critical because, by definition, the category of potential new defendants consists of entities that made no statements upon which the public relied in connection with the purchase or sale of securities of the issuer. Accordingly, petitioner's test would necessarily expand private liability for Section 10(b) to "reach[ ] persons who do not engage in the proscribed activities at all" — the very outcome that this Court rejected in *Central Bank*, 511 U.S. at 176.

These concerns are not merely hypothetical. Fact patterns and business relationships drawn from allegations in recently filed securities cases provide real-world scenarios in which petitioner's "but-for" view of causation would create new risks of costly litigation and potential liability that Congress never intended. Moreover, an examination of post-*Central Bank* securities complaints that allege third-party involvement demonstrates why the absence of a workable distinction between non-actionable aiding and abetting and a new form of secondary liability — much less a distinction authorized by Congress — is fatal to petitioner's argument. Should potential private liability be expanded to third parties who may have (or may be considering) a business relationship with the issuer, then a new form of risk would be created for third parties who made no public statements, who did not owe any fiduciary duty to the primary actor's

shareholders, and upon whose actions those shareholders did not rely. This new category of prospective defendants could include vendors, customers, potential business partners, outside advisers, and consultants; indeed, even parties who were themselves victimized and financially damaged by the issuer's alleged scheme could be swept within petitioner's view of liability. These illustrations — drawn from the annals of pending and recent litigation – show that corporate relationships do not fit neatly into the matrix of liability petitioner advances.

A rule that subjects third parties or other outsiders to private civil liability for the misstatements, omissions, and schemes of an issuer will assuredly generate uncertainty. Consider, for example, the burden of monitoring the public statements of all vendors with whom one does business. Then consider the reality that any such burden would be compounded by the additional burden of assessing whether each statement is accurate and not misleading. Consider the further burden of assessing whether any statement deemed inaccurate is material to the financial condition of the issuer. And then consider that all of these assessments would have to be undertaken by a third party who lacks access to internal corporate information of the issuer. Indeed, if the inaccuracy of the issuer's statements could be readily ascertained by publicly available information there would be no reasonable reliance by an investor and, hence, no Section 10(b) violation. In short, the new duties and standards that petitioner advocates offer little in the way of practical benefit to investors but impose substantial burdens and costs on others.

A. Vendors

In a class-action complaint involving a vendor and its customer,[6] plaintiffs alleged that one of defendant's subsidiaries engaged in a scheme to overstate its revenues by nearly $900 million. *In re Royal Ahold*, Compl. ¶ 13. Plaintiffs alleged that defendant's subsidiary colluded with its vendors to inflate revenues derived from supplier rebates by preparing false rebate confirmations. *Id.* ¶ 102.

The vendors were not named as defendants in the class-action suit. Yet, the allegations in that case shed light on the expanded litigation exposure vendors would face under petitioner's conception of "scheme liability" and "but-for" causation. Vendors might conclude that they are required to monitor their customers' public disclosures and financial statements regarding the validity of the accounting treatment for such rebates (and other inter-firm transactions). Such a requirement would be extremely costly and could not even be accomplished in any practical way since vendors do not have access to sufficient information to analyze the materiality of such public statements.

B. Customers

In another class-action complaint involving a vendor and its customer,[7] plaintiffs alleged that defendant ("the Vendor") inflated earnings to meet growth and earning

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[6] *In re Royal Ahold N.V. Secs. & ERISA Litig.*, 03-CIV-01539 (D.Md. Filed January 23, 2004); https://ecf.mdd.uscourts.gov/cgi-bin/login.pl?106325525506022-L_835_0-1 ("*In re Royal Ahold*").

[7] *Laborers Local 1298 Pension Fund, v. Campbell Soup Co.*, 00-CIV-152 (D.N.J. Filed July 27, 2000); http://securities.stanford.edu/1013/CPB00/ ("*Laborers Local 1298*").

estimates. *Laborers Local 1298*, Compl. ¶ 2. Plaintiffs alleged that defendant improperly recognized material amounts of revenue as sales which were in fact a sham and not properly recognizable revenue. *Id.* ¶ 9. The next year, customers purchased much less from the Vendor and the Vendor announced unexpected losses, causing its stock price to drop dramatically. *Id.* ¶ 8.

In this situation, it is fair to inquire whether petitioner's notion of "scheme liability" and "but-for" causation would require customers to monitor their vendors' public disclosures and financial statements regarding the validity of the accounting treatment for sales. Wholly aside from the cost of such an endeavor, there is the virtual certainty that the customers would lack access to sufficient information to make an exhaustive, accurate analysis. Contrary to petitioner's contention, Section 10(b) does not make a customer his vendor's bookkeeper.

C. Parties in Merger Discussions

In one recent class-action complaint,[8] plaintiffs accused defendant (a regional company) of issuing false and misleading statements in connection with an Agreement and Plan of Merger ("the Merger Agreement") it entered into to be acquired by a large national company. *In re Northpoint*, Compl. ¶ 31.

Shortly after announcing the Merger Agreement, the defendant was forced to restate its financials and reveal an inability to collect nearly one third of its receivables. *Id.* ¶ 5.

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[8] *In re Northpoint Comm'ns. Group. Inc. Secs. Litig.*, No. C-01-1473 (N.D. Cal. Filed Aug. 23, 2001); http: securities. stanford.edu 1017 NPNTQ01 ("*In re Northpoint*").

In connection with the restatement, the defendant issued a press release indicating that the merger was still on track, but did not mention the Merger Agreement's provision allowing the acquirer to withdraw from the merger if defendant's business took an adverse turn. *Id.* ¶ 5. Nine days later, the national company withdrew from the Merger Agreement and terminated its funding, citing the defendant's poor financial condition and false quarterly reports. The defendant's stock plummeted. *Id.* ¶ 6.

The complaint did not name the national company as a defendant. Indeed, the national company had been kept in the dark about defendant's financial condition and played no role in defendant's false public statements. It is fair to ask, however, whether the "but-for" causation that petitioner urges here would have required the national company to monitor and issue corrections for all public statements by its potential merger partner. Such a duty would be particularly onerous and costly if the national company had to assess whether the misstatements were material and then hire counsel, accountants, and others to correct any inaccuracies. In this real-world situation, the defendant's alleged scheme was directed at the national company as well as at its own shareholders. Yet, petitioner's overly expansive theory of "scheme liability" has the troublesome potential of creating a risk of liability for the victimized national company.

D. Partnerships

1. In a class-action complaint filed early this year in the Southern District of New York,[9] plaintiffs alleged

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[9] *Elec. Workers Pension Fund v. Nuvelo, Inc.*, Case No. 07-CIV-0975 (S.D.N.Y. Filed Feb. 9, 2007); http://securities.stanford.edu/1037/NUVO_01/ ("*Elec. Workers*").

that defendant issued false and misleading statements about the development and regulatory review of a new product. *Elec. Workers*, Compl. ¶ 35 Defendant is alleged not to have divulged the fact that its collaborator (the "Collaborator"), a larger company, opted to grant a license rather than invest additional development funds after a review of privately collected data. *Id.* ¶ 11. Defendant instead represented its Collaborator's decision to opt out of funding further development as "purely a strategic decision . . . not necessarily a decision regarding" the product or the defendant." *Id.* The Collaborator made no statements about the issuer that were alleged to be misleading.

2. In a class-action complaint filed in 2002,[10] plaintiffs alleged that defendant, a biotechnology company, disseminated materially false and misleading statements regarding the clinical success of its drug trials, its compliance with FDA filing requirements, and its estimated revenue. *Krosser*, Compl. ¶ 1. Plaintiffs alleged that the clinical trials were not successful, that the defendant filed an inadequate application with the FDA, and that the estimated revenues were baseless and misleading. *Id.* ¶ 71. When the FDA rejected the application, the issuer's stock price dropped. *Id.* ¶ 79.

Consistent with settled law, plaintiffs did not sue the large pharmaceutical company that partnered with defendant and provided substantial funding. The large pharmaceutical company had no duty to defendant's shareholders, took no part in defendant's publications, and defendant's shareholders could not have relied on the larger company to

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[10] *Krosser v. Imclone Sys., Inc.*, Case No. 02-CIV-00136 (S.D.N.Y. Filed Jan. 8, 2002); http: securities.stanford.edu 1023 IMCL02-01 ("*Krosser*").

monitor defendant's public statements. Would petitioner's arguments in the present case expand private liability to reach such situations? If so, then the notion of "scheme liability" would impose increased transactions costs that clearly could dissuade large companies from partnering with smaller ones.

3. In a class-action complaint filed in 2000,[11] plaintiffs alleged that defendant manufacturer made misleading statements indicating that its technology had been approved by a private industry regulator (the "Regulator"). *Birnbaum*, Compl. ¶ 4. Plaintiffs further alleged that without the Regulator's imprimatur there would be no demand for defendant's products. *Id.* ¶ 30. But, the Regulator had not approved the technology and allegedly sent defendant a private cease-and-desist letter demanding that it discontinue its public claims to the contrary. *Id.* ¶ 5. The false-approval claims allegedly allowed defendant to mislead plaintiffs regarding its financial health and prospects. *Id.* ¶ 31. Again, it is pertinent to inquire whether petitioner's notion of "scheme liability" would expand Section 10(b)'s reach to permit a lawsuit against such parties as the Regulator, which was essentially a victim of the issuer's false statements.

These real-life examples clearly demonstrate that one need not resort to hypotheticals to conclude that petitioner's theory of "scheme liability" would nullify the distinction between primary and secondary liability that informed this Court's decision in *Central Bank*. The result would be an upsurge in third parties becoming defendants in private litigation for actions that do not violate Section 10(b) as that

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[11] *Birnbaum v. Terayon Comm'ns Sys. Inc.*, Case No. 00-CIV-03912 (C.D. Cal. Filed Apr. 13, 2000); http://securities.stanford.edu/1014/TERN00 ("*Birnbaum*").

statute has long been interpreted. At the end of the day, petitioner's contention that Section 10(b) should be construed flexibly to cover a variety of "schemes" misses a fundamental point: to say that a "scheme" violates the statute does not mean that a particular third party has violated the statute. As Congress and this Court have determined, liability to private plaintiffs should be based on measuring a defendant's conduct against statutory standards and elements, not on measuring the depth of a defendant's pockets. *Tellabs, Inc., v. Makkor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2508 (2007).

II. CONGRESS HAS NOT EXPANDED 10(b) LIABILITY FOR PRIVATE LAWSUITS AGAINST SECONDARY PARTIES

Petitioner's formulation of "scheme liability" would radically expand Section 10(b) beyond the scope authorized by Congress. Petitioner's arguments are contrary to the statutory language and to all appropriate indicia of legislative intent. Indeed, Congress has given no indication that it has created private liability in these circumstances, and multiple clear indications that it has not. In at least four enactments since the *Central Bank* decision, Congress has legislated major changes to class action and securities law procedures. If Congress intended to impose a duty on secondary parties to monitor representations made by their business associates and others, it had ample opportunity to do so.

A. Private Securities Litigation Reform Act

Shortly after the decision in *Central Bank*, Congress passed the Private Securities Litigation Reform Act ("PSLRA") in 1995 (and amended it in 1997). 15 U.S.C. §§

78u-4 *et seq.* The PSLRA was an extensive overhaul of class-action litigation that sought to curb class-action abuses, including professional claimants, the race to the courthouse, and awards of excessive attorneys' fees. The PSLRA did not create a Section 10(b) secondary liability scheme in favor of private plaintiffs. To the contrary, the PSLRA added a separate section that authorized the SEC — and not private parties — to pursue administrative remedies against secondary actors who aid and abet violations of Section 10(b). *See* page 17, *infra.*

B. Securities Litigation Uniform Standards Act

The Securities Litigation Uniform Standards Act of 1998, 15 U.S.C.A. § 78bb(f) ("SLUSA"), was designed to protect the integrity of the federal securities laws. SLUSA preempted certain state-law actions for fraud, negligence, or breach of fiduciary duty and allowed federal courts to stay discovery in state-court actions that might interfere with the federal securities action. It did not create the private Section 10(b) liability for secondary parties that petitioner urges in this case.

C. Class Action Fairness Act

The Class Action Fairness Act of 2005, 28 U.S.C. §§ 1332(d), 1453, and 1711-1715, strengthened certain provisions of the PSLRA by imposing new requirements for approval of class-action settlements and the award of attorneys' fees, as well as making it easier to remove state-law class-actions to federal court by permitting minimal diversity, an aggregation of claims and eliminating the requirement that defendants unanimously consent to removal. Once again, Congress did not address Section 10(b)

secondary liability in this Act, and petitioner's argument in favor of unbridled private liability for secondary actors is fundamentally inconsistent with the curbs Congress enacted to eliminate the excesses of lawyer-driven litigation.

D. Sarbanes- Oxley Act

The Sarbanes-Oxley Act of 2002 (15 U.S.C.A. §§ 78d-3 *et al.*) the most recent overhaul of the federal securities laws, instituted additional monitoring and disclosure mechanisms for public companies, but nothing remotely like the regime of new duties and private liability petitioner urges on this Court. Indeed, in significant ways petitioner's view of Section 10(b) would render important provisions of Sarbanes-Oxley redundant. The Act redefined the responsibilities of attorneys, accountants and management to review and monitor company policies and disclosure. But the Sarbanes-Oxley Act does not require company outsiders to report Section 10(b) breaches to company management or the public. Imposing these duties on outsiders is duplicative and expansive of preexisting statutory duties on others: Section 10A of the Exchange Act, 15 U.S.C.A. § 78j-1 (2002), requires accountants to report findings of illegal acts to the independent audit committee or SEC; and Section 307 of the Sarbanes-Oxley Act provides a reporting-up mechanism for attorneys who suspect "evidence of a material violation of securities law or a breach of fiduciary duty" by their clients.[12]

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[12] Under Sarbanes-Oxley, attorneys must report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company up through the company's hierarchy and to the public if the company fails adequately to correct its actions. The duty to monitor and report wrongdoing does not extend beyond these named groups.

In addition, Sarbanes-Oxley augmented the carefully circumscribed regulatory regime to allow the SEC — but not private plaintiffs — discretion to commence actions to obtain compensation for investors from secondary parties whose participation in statutory misconduct is sufficiently egregious to warrant sanction. Sarbanes-Oxley Act of 2002 § 308(a), 15 U.S.C.A. § 7246(a). Accordingly, there is no merit to petitioner's alarmist contention that "[w]ithout fear of [Section 10(b)] private liability, business partners would have an incentive to provide false documents" and that secondary actors would "be free from liability."[13]

III. CONGRESS GAVE THE SEC DISCRETION TO DETERMINE THE PURSUIT OF SECTION 10(b) CIVIL CLAIMS AGAINST SECONDARY ACTORS

Congress authorized the SEC to pursue secondary actors under Section 20(e) of the Exchange Act. In doing so, Congress intended to have the SEC's discretion guide whether civil claims should be brought against secondary actors. 15 U.S.C. § 78u(d)(1) empowers the SEC to exercise "its discretion [to] bring an action in the proper district court ... [and] enjoin such acts or practices" that violate the securities laws. ("Section 21(d)(1)"). Section 21(d)(1) specifies that secondary actors will be pursued by the SEC "in its discretion." Moreover, Section 308 of the Sarbanes-Oxley Act — the "Fair Funds" provision — permits investors to be compensated for injuries caused by the activity of secondary actors. This combination of statutory provisions ensures that secondary actors whom Congress has deemed to

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[13] Pet. Br. 35.

be culpable are not "free from liability" as petitioner suggests. In contrast, petitioner's "scheme liability" approach to Section 10(b), would place that "discretion" in the hands of private litigators without any Congressional authorization. But, as Congress and the Courts have seen, private plaintiffs have no incentives to limit the bounds of "lawyer-driven" litigation. The Court should, accordingly, reject petitioner's effort to create a new form of private liability not contemplated or authorized by Congress.

A. Congress Authorized Only the SEC to Pursue Secondary Actors

Under Section 20(e) of the Exchange Act, the SEC is authorized to pursue persons who provide substantial assistance to violators of Section 10(b):

> For purposes of any action brought by the [SEC] under paragraph (1) or (3) of section 78u(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, **shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided**.

(Emphasis added).[14]

If petitioner's view of Section 10(b) were correct, therefore, Section 20(e) would be redundant. *See Mackey v.*

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[14] Section 10(b) 15 U.S.C. § 78j - is part of the "chapter" referred to in Section 20(e).

Lanier Collection Agency & Service, Inc., 486 U.S. 825, 837 (1988) (Court is "hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law"). Although the SEC is empowered to hold secondary actors liable for aiding and abetting or causing violations of Section 10(b), private plaintiffs are not.

In contrast to the specific provisions for SEC enforcement proceedings against secondary actors, Congress created no such authorization for private suits under Section 10(b). As this Court noted "[i]f ... Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' .... it did not." *Central Bank*, 511 U.S. at 177 (citation omitted). Because Congress never "enacted a general civil aiding and abetting statute ... there is no general presumption that the plaintiff may also sue aiders and abettors" for damages it sustains as the result of a statutory violation. *Id.* at 182 (citation omitted). More telling is that while Congress did not prohibit aiding and abetting in Section 10(b), it specifically prohibited aiding and abetting in several other provisions of the securities laws. *Id.* at 182-83.[15]

Similarly, the fact that Congress separately and exclusively authorized the SEC to pursue persons who substantially assist violations of Section 10(b) establishes that Section 10(b) does not create the expansive private

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[15] Petitioner attempts to avoid the consequences of this statutory language by arguing that respondents themselves engaged in barred deceptive practices and are therefore primary actors. Pet. Br. 20 n. 5 citing *Central Bank*, 511 U.S. at 176. To the contrary, petitioner's "but - for" analysis establishes that the conduct it challenges is the respondents' alleged aid to Charter: "Charter could not have succeeded in publishing the false financial statements that injured investors 'but for' the deceptive acts of [Defendants]." Pet. Br. 40.

liability urged in this case. If Section 10(b) already authorized the pursuit of secondary actors, then there would have been no need for a specific, separate provision in the same statute that authorizes the SEC to pursue civil claims against aiders and abettors.

B. The "Fair Funds" Provisions of the Sarbanes-Oxley Act Provide Compensation to Victims

Among the additional weapons in the SEC's enforcement arsenal is Section 308(a) of the Sarbanes-Oxley Act, entitled "Civil penalties added to disgorgement funds for the relief of victims." 15 U.S.C. § 7246(a). Section 308(a) authorizes the SEC to seek orders from federal courts placing civil penalties obtained against violators in a "disgorgement fund" created for the benefit of the victims. *Id.*[16] When moving for such relief, the SEC submits to the court a plan describing how and to whom the disgorged funds and penalties will be distributed. The court then determines whether the plan's details are "fair and reasonable." *E.g.*, *Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC*, 467 F.3d 73, 82-83 (2d Cir. 2006) (citing *SEC v. Wang*, 944 F.2d 80, 85 (2d Cir. 1991)).

Section 308 is part of a legislative structure that provides disincentives for parties while simultaneously compensating injured investors. In passing prior securities legislation, Congress had observed that punishing violators

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[16] Section 308(a) authorizes the SEC to direct – in administrative proceedings — that the penalties be placed in disgorgement funds. Moreover, Section 308(b) authorizes the SEC to accept donations and gifts for inclusion in disgorgement funds.

and deterring future violations required a combination of disgorgement and civil penalties:

> Disgorgement merely requires the return of wrongfully obtained profits; it does not result in any actual economic penalty or act as a financial disincentive to engage in securities fraud .... The Committee therefore concluded that authority to seek or impose substantial money penalties, in addition to disgorgement of profits, is necessary for the deterrence of securities law violations ....

1990 U.S.C.C.A.N. 1379, 1384-86 (quoting the U.S. House of Representatives Report on the Securities Enforcement Remedies Act and Penny Stock Reform Act of 1990). Because Section 308(a) allows the SEC to add penalties to disgorgement funds, the Fair Funds provision increases compensation to victims while simultaneously providing significant disincentives for potential violators of the securities laws.

C. The "Fair Funds" Provision Has Compensated Victims

The SEC has applied the "Fair Funds" provision to secondary actors — aiders and abettors — and thereby garnered compensation for injured investors while providing disincentives for future violations of the securities laws. For example, in a complaint the SEC filed in the United States District Court in Houston, Merrill Lynch & Co., Inc. was alleged to have aided and abetted Enron Corporation in committing securities fraud. *See* SEC Litigation Release No. 18038, 2003 SEC LEXIS 620 at *1 (Mar. 17, 2003). Along

with the filing of the complaint, the SEC also announced that Merrill Lynch had agreed to a settlement:

> [T]he Commission has agreed to accept Merrill Lynch's offer to settle this matter. Merrill Lynch, without admitting or denying the allegations in the complaint, has agreed to pay $80 million dollars in disgorgement, penalties and interest and has agreed to the entry of a permanent anti-fraud injunction prohibiting future violations of the federal securities laws. The Commission intends to have these funds paid into a court account pursuant to the Fair Funds provisions of Section 308(a) ... for ultimate distribution to the victims of the fraud.

Id. at *1-*2. The SEC also alleged that J.P. Morgan Chase & Co. aided and abetted Enron Corporation in securities fraud – and Morgan, too, "agreed to pay disgorgement, penalties and interest in the amount of $135 million." SEC Litigation Release No. 18252, 2003 SEC LEXIS 1775 (July 28, 2003).

These examples show that the victim compensation plan Congress created is working and has provided substantial recoveries to investors even in the absence of the open-ended Section 10(b) private liability petitioner advocates. Companies that have been the subjects of Section 308(a) proceedings cannot reasonably be considered to have been "free from liability" or to be lacking incentive to avoid future violations of the securities laws. But that is the only remedy Congress created.

In the final analysis, only Congress is empowered to determine the efficacy of the remedies it enacted. Consistent

with the carefully balanced statutory scheme, and with this Court's well-settled rules of statutory construction, petitioner's plea for judicial creation of new forms of liability should be rejected.

CONCLUSION

The judgment should be affirmed.

Respectfully submitted.

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No. 06-43

In The
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., *et al.*,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

MOTION FOR LEAVE TO FILE BRIEF OUT OF TIME AND BRIEF *AMICI CURIAE* OF FORMER SEC COMMISSIONERS IN SUPPORT OF PETITIONER

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MOTION FOR LEAVE TO FILE BRIEF OUT OF TIME OF *AMICI CURIAE* FORMER SEC COMMISSIONERS IN SUPPORT OF PETITIONER

Pursuant to Supreme Court Rule 37.3, William H. Donaldson and Arthur Levitt, Jr., former Chairmen of the Securities and Exchange Commission, and Harvey J. Goldschmid, former Commissioner of the SEC, respectfully move for leave to file a brief *amici curiae* out of time, and to file the accompanying brief in support of the petitioner.

Amici regret missing the deadline for filing. This is one of the most important securities cases to be heard by this Court in many years. As former Chairmen and Commissioners of the Securities and Exchange Commission, *amici* have been involved extensively in securities law policy and enforcement and respectfully believe they have a perspective that might assist in the Supreme Court's consideration of the issue now pending before the Court.

Amici expected that the Solicitor General would support the past and current position of the Securities and Exchange Commission on the issue presented and file an *amicus curiae* brief on behalf of the United States in support of petitioner. *Amici* apologize for the late motion, but saw no need to file this brief until after June 11, 2007, when petitioner's brief was filed and an *amicus* brief of the United States supporting petitioner was not. Plaintiffs consent to the filing of this *amici* brief; Defendants do not. Since Defendants have been granted an extension of time

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to file their brief until August 15, 2007, the granting of this motion would not prejudice them.

Respectfully submitted,

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BRIEF *AMICI CURIAE* OF FORMER SEC COMMISSIONERS IN SUPPORT OF PETITIONER

INTEREST OF *AMICI*[1]

This *amici curiae* brief is submitted by William H. Donaldson, former Chairman of the Securities and Exchange Commission (2/18/03 – 6/30/05, appointed by President George W. Bush), Arthur Levitt, Jr., former Chairman of the

[1] This brief was not authored in whole or in part by counsel for a party. No person or entity other than *amici curiae* or their counsel made a monetary contribution to the preparation or submission of this brief. Plaintiffs' blanket letter of consent to the filing of this brief is on file with the Court. Defendants do not consent to the filing of this brief.

SEC (7/27/93 – 2/9/01, appointed by President William J. Clinton), and Harvey J. Goldschmid, former Commissioner of the SEC (7/31/02 – 7/31/05, appointed by President George W. Bush) in support of Petitioner. Throughout our tenure of service at the SEC, during Administrations of both political parties, we have been involved in Commission policy and enforcement regarding so-called "fraudulent scheme liability." We believe the continued viability of private actions based on such liability is essential for the protection of the nation's investors and the integrity of our financial markets.

This is one of the most important securities cases to be heard by this Court in many years. It is critical to the antifraud purposes of the federal securities laws that actors, other than issuers and their officers and directors, who actively engage in deceptive conduct – for the purpose and with the effect of creating a false statement of material fact in the disclosure of a public corporation – continue to be held liable in private actions.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, as the SEC explained recently, include "conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words." *Amicus Curiae* Brief of the SEC filed October 22, 2004 in *Simpson v. AOL Time Warner, Inc.* (*Cal. St. Teachers Ret. Sys. v. Homestore.com, Inc.*, No. 04-55665 (9th Cir.), at 8 (quoted in *In re Enron Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 43146, at *165 (S.D. Tex. June 5, 2006), *rev'd, Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372 (2007)). We believe that this Court's resolution of the issue of fraudulent scheme liability in the instant case will have a profound effect on the continued deterrence of fraud, the

ability of defrauded investors to recover their losses, and the overall fairness and effectiveness of our securities markets. We urge this Court to reaffirm liability for actors who actively engage in deceptive conduct as part of a fraudulent scheme.

INTRODUCTION

The federal securities laws reflect Congress' broad purpose to protect investors and preserve the integrity of the markets by deterring, punishing, and allowing civil remedies for manipulative and deceptive conduct. In particular, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), prohibits "any manipulative or deceptive device or contrivance" and provides a broad grant of authority to the Commission to enact rules "in the public interest or for the protection of investors." The Commission promulgated Rule 10b-5, 17 C.F.R. §240.10b-5, to deter and prevent fraud.

Together Section 10(b) and Rule 10b-5 are the chief weapons in the SEC's arsenal against securities fraud and the principal means by which defrauded investors recover their losses from those who perpetrate frauds. If allowed to stand, the decision below would make virtually invulnerable those who actively, purposely, and with market effect, engage in deceptive conduct and would cause grave harm. The decision conflicts with the language and purposes of Section 10(b), the historical position of the Commission, and well-grounded judicial precedent.

The decision below immunizes non-issuers who commit securities fraud from private liability merely because they were cunning enough to avoid making a

public statement. Those who – with purpose and effect – actively engage in fraudulent acts as part of a scheme with the issuer to defraud investors should be held primarily liable, regardless of whether they speak to the market, assuming all the other requirements to plead and prove a claim under Section 10(b) and Rule 10b-5 are met.

Fraudulent scheme liability neither results in undue liability exposure for non-issuers, nor an undue burden upon capital formation. Holding liable wrongdoers who actively engage in fraudulent conduct that lacks a legitimate business purpose does not hinder, but rather enhances, the integrity of our markets and our economy. We believe that the integrity of our securities markets is their strength. Investors, both domestic and foreign, trust that fraud is not tolerated in our nation's securities markets and that strong remedies exist to deter and protect against fraud and to recompense investors when it occurs. The decision below, if left standing, would dramatically undermine private enforcement of our securities laws and investor confidence in our securities markets.

SUMMARY OF ARGUMENT

Meritorious private actions to enforce the federal antifraud securities laws are an essential supplement to government actions. Private actions are the principal means by which defrauded investors recover their losses due to the Commission's limited resources and powers. The Commission's traditional position has been that a party commits a primary securities fraud violation for which it may be held liable in a private action by actively engaging in fraudulent conduct as part of a scheme to

defraud investors, even if it does not make a public statement. Such "fraudulent scheme liability" is consistent with the purposes of the federal securities laws and essential to the protection of investors, the integrity of the securities markets, and the ability of America to remain the world's leader in capital formation. The Court should reverse the decision below and reaffirm the availability of fraudulent scheme liability.

ARGUMENT

The broad antifraud purposes of Section 10(b) of the Securities Exchange Act of 1934, have long been fully recognized by this Court. *See, e.g., SEC v. Zandford*, 535 U.S. 813, 821 (2002) (noting statute's broad language and interpretation); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (noting Congress' intention "to insure honest securities markets and thereby promote investor confidence"); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices"); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972) (noting statute's broad language accords with Congress' "fundamental purpose . . . to achieve a high standard of business ethics in the securities industry") (internal quotation marks omitted).

This Court and the SEC have also "long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)." *Tellabs,*

Inc. v. Makor Issues & Rights, Ltd., 2007 U.S. LEXIS 8270, *9 (June 21, 2007). "[P]rivate securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses – a matter crucial to the integrity of domestic capital markets." *Id.* at *24 n.4 (internal quotation marks omitted).

The Commission's traditional position has been that a person may commit a "manipulative or deceptive" act constituting a primary violation of Section 10(b) without making a public statement. The SEC consistently has expressed this position through rulemaking,[2] *amicus* briefs in private litigation,[3] civil actions brought by the

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[2] *See, e.g.*, Rule 10b-5(a) and (c), and many other rules promulgated by the Commission under Section 10(b) prohibiting manipulative or deceptive acts without requiring misstatements or omissions. Rule 10b-1, 17 C.F.R. §240.10b-1; Rule 10b-3, 17 C.F.R. §240.10b-3; Rule 10b-5-1, 17 C.F.R. §240.10b-5-1; Rule 10b-5-2, 17 C.F.R. §240.10b-5-2; Rule 10b-10, 17 C.F.R. §240.10b-10; Rule 10b-16, 17 C.F.R. §240.10b-16; Rule 10b-17, 17 C.F.R. §240.10b-17.

[3] *See, e.g.*, *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) ("We agree with the SEC that engaging in a transaction, the principal purpose and effect of which is to create the false appearance of fact, constitutes a 'deceptive act' "), *petition for cert. filed sub nom. Cal. St. Teachers Ret. Sys. v. Homestore.com, Inc.*, 75 U.S.L.W. 3236 (U.S. Oct. 19, 2006) (No. 06-560); *In re Enron Corp. Sec. Litig.*, 2006 U.S. Dist. LEXIS 43146, at *165 (S.D. Tex. June 5, 2006) (noting Commission's argument "deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words. For example, if an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding the company debt, it has achieved the same deception, and liability should be equally available"), *rev'd, Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372 (2007); *Amicus Curiae* Brief of the SEC filed April, 1998 in *Klein v. Boyd*, No. 97-1142 (3d Cir.).

Commission,[4] and the Commission's own administrative adjudications.[5]

The SEC's position is both reasonable and necessary for the protection of investors. An intentional scheme to engage in sham transactions for the purpose of artificially inflating a public corporation's financial statements, as alleged in the instant case, is anathema to what Congress sought to accomplish by enacting Section 10(b).

Although the Commission has the authority to proceed against aiders and abettors, 15 U.S.C. §78t(e), private litigants do not. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Investors must rely primarily on private actions to recover when

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[4] *See, e.g., SEC v. Dibella*, 2005 U.S. Dist. LEXIS 31762, *11 (D. Conn. Nov. 29, 2005) (noting Commission's position subsections (a) and (c) prohibit schemes to defraud regardless whether any material statements or omissions were made).

[5] *See, e.g., In re Robert W. Armstrong, III*, 2005 SEC LEXIS 1497, *23 (June 24, 2005) (misstatement or omission not required for liability under subsection (a) or (c) of Rule 10b-5: "A person's conduct as part of a scheme constitutes a primary violation when the person directly or indirectly engages in a manipulative or deceptive act as part of the scheme. . . . Schemes used to artificially inflate the price of stocks by creating phantom revenue fall squarely within both the language of section 10(b) and its broad purpose, to prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded, and nothing in the language of Section 10(b) or Rule 10b-5 or in the case law interpreting them shields a defendant from liability for direct participation in such a scheme") (internal quotation marks omitted); *In re Cady, Roberts & Co.*, 1961 SEC LEXIS 386, *9, 40 S.E.C. 907, 911 (Nov. 8, 1961) ("These anti-fraud provisions are not intended as a specification of specific acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others").

defrauded. The SEC's disgorgement and civil money penalty powers, although enhanced by the Sarbanes-Oxley Act, are limited, and will generally cover only a fraction of the damage done to investors by serious securities fraud. Moreover, the SEC with limited resources cannot possibly undertake to bring actions in every one or even most of the financial fraud cases that have proliferated over the past few years.

Thus, the elimination of fraudulent scheme liability would mean, in practical terms, that defrauded investors would not be able to recover their losses from any party other than the public company that issued the financial or other public statements. But in many fraud cases, the issuer becomes bankrupt or unable to satisfy a judgment once the fraud is exposed. If the only party investors could proceed against were the issuer (and its directors and officers), defrauded investors would be unable to recover much of their losses and public confidence in the markets would surely suffer. Private cases, so long as they are well-grounded, are an important enforcement mechanism supplementing the SEC in the policing of our markets.[6] Most often, the larger the frauds, the greater investors must rely on private cases to recover their losses. In the *Enron* case, for example, the Commission and the Department of Justice were able to obtain only $440 million for investors (*see* http://www.sec.gov/divisions/enforce/claims/enron.htm) out of total claimed losses of approximately $40 billion (*see* Petition for Writ of Certiorari at 5 n.8, *The*

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[6] In enacting the Private Securities Litigation Reform Act of 1995, 109 Stat. 737, Congress "installed both substantive and procedural controls" designed to ensure private cases are well-grounded. *Tellabs*, 2007 U.S. LEXIS, at *23.

Regents of the Univ. of Cal. v. Merrill Lynch Pierce Fenner & Smith, Inc., (No. 06-1341)).

The most serious effect of the elimination of fraudulent scheme liability would be on deterrence and the integrity of the markets – the foundations of public confidence and trust in the markets. *See Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005) ("The securities statutes seek to maintain public confidence in the marketplace. . . . by deterring fraud, in part, through the availability of private securities fraud actions"); *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (private securities fraud actions provide "a most effective weapon in the enforcement" of securities law and are "a necessary supplement to Commission action"). What signal would it send to banks, broker-dealers, accountants, and lawyers to relieve them of all possibility of private liability so long as they do not speak publicly about the transactions with respect to which they perform their essential services? What signal would it send to investors to deprive them of the ability to recover significant parts of their losses in cases where actors actively and purposefully engaged in a fraudulent scheme?

The continuation of fraudulent scheme liability will not harm American competitiveness; in fact, investor faith in the safety and integrity of our markets *is* their strength. The fact that our markets are the safest in the world has helped make them the strongest in the world. Capital formation through the United States securities markets since the enactment of the federal securities laws has been a resounding success.

CONCLUSION

We respectfully urge this Court to reverse the decision of the court below and to reaffirm the availability of fraudulent scheme liability under Section 10(b) and Rule 10b-5.

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To The United States Court Of Appeals
For The Eighth Circuit

BRIEF FOR FORMER SEC COMMISSIONERS AND OFFICIALS AND LAW AND FINANCE PROFESSORS AS *AMICI CURIAE* SUPPORTING RESPONDENTS

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INTEREST OF *AMICI CURIAE*[*]

Amici curiae include a bipartisan group of former Chairmen, Commissioners and officials of the United States Securities and Exchange Commission (SEC), as well as prominent law and finance professors whose fields of academic inquiry include securities regulation, class-action practice, and law and economics. *Amici* have devoted substantial parts of their professional careers to implementing, drafting, and/or studying the federal securities laws, including how those laws should be interpreted to ensure the protection of investors and the promotion of efficiency, competition, and capital formation.

This brief reflects the consensus view of the *amici*, all of whom believe that the decision below should be affirmed. Each individual *amicus* may not endorse every argument presented herein, however. The former Chairmen, Commissioners, officials, and professors joining this brief as *amici*, listed alphabetically by category, are:

The Honorable Roderick M. Hills, who served as the Chairman of the SEC from 1975 through 1977.

The Honorable Harvey L. Pitt, who served as the Chairman of the SEC from 2001 through 2003, and who also served as General Counsel of the SEC from 1975 through 1978.

The Honorable Harold M. Williams, who served as the Chairman of the SEC from 1977 through 1981.

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[*] This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici* and their counsel contributed monetarily to the preparation or submission of this brief. *See* note 1, *infra*. The parties have consented to the filing of this brief and copies of their letters of consent have been lodged with the Clerk of the Court.

The Honorable Charles C. Cox, who served as a Commissioner of the SEC from 1983 through 1989, and as Chief Economist of the SEC from 1982 through 1983.

The Honorable Edward H. Fleischman, who served as a Commissioner of the SEC from 1986 through 1992.

The Honorable Stephen J. Friedman, who served as a Commissioner of the SEC from 1980 through 1981, and who is the President of Pace University.

The Honorable Joseph A. Grundfest, who served as a Commissioner of the SEC from 1985 through 1990, and who is the William A. Franke Professor of Law and Business and Co-Director of the Rock Center on Corporate Governance at Stanford Law School.[1]

The Honorable Isaac C. Hunt, Jr., who served as a Commissioner of the SEC from 1996 through 2001.

The Honorable Roberta S. Karmel, who served as a Commissioner of the SEC from 1977 through 1980, and who is the Centennial Professor of Law at Brooklyn Law School.

The Honorable Philip R. Lochner, Jr., who served as a Commissioner of the SEC from 1990 through 1991.

The Honorable Aulana L. Peters, who served as a Commissioner of the SEC from 1984 through 1988.

The Honorable Richard Y. Roberts, who served as a Commissioner of the SEC from 1990 through 1995.

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[1] Professor Grundfest has been retained by respondents to provide counsel in this matter. In that capacity he submitted a legal memorandum to the SEC that addressed some of the subjects addressed in this brief. Professor Grundfest was not, however, separately compensated in connection with the preparation of this brief.

The Honorable Laura S. Unger, who served as a Commissioner of the SEC from 1997 through 2002, and as Acting Chairman from February to August 2001.

The Honorable Steven Wallman, who served as a Commissioner of the SEC from 1994 through 1997.

James Doty, who served as General Counsel of the SEC from 1990 through 1992.

Simon M. Lorne, who served as General Counsel of the SEC from 1993 through 1996.

Professor Stephen M. Bainbridge, the William D. Warren Professor of Law at the University of California, Los Angeles, Law School.

Professor Stephen J. Choi, the Murray and Kathleen Bring Professor of Law, at New York University School of Law.

Professor Robert C. Clark, the Harvard University Distinguished Service Professor, Austin Wakeman Scott Professor of Law, and Former Dean at Harvard Law School.

Professor John C. Coates, the John. F. Cogan, Jr. Professor of Law and Economics at Harvard Law School.

Professor Richard A. Epstein, the James Parker Hall Distinguished Service Professor of Law and Director, the Law and Economics Program, at the University of Chicago Law School, and the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution.

Professor Allen Ferrell, the Greenfield Professor of Securities Law at Harvard Law School.

Professor Larry E. Ribstein, the Mildred Van Voorhis Jones Chair in Law at the University of Illinois College of Law.

Professor Richard W. Roll, Ph.D, Japan Alumni Professor of International Finance, at the Anderson Graduate School of Management, University of California, Los Angeles.

Professor Roberta Romano, the Oscar M. Ruebhausen Professor of Law and Director of the Center for the Study of Corporate Law at Yale Law School.

Professor Kenneth E. Scott, the Ralph M. Parsons Professor of Law and Business at Stanford Law School.

Professor Jeff Strnad, the Charles A. Beardsley Professor of Law at Stanford Law School.

INTRODUCTION AND SUMMARY OF ARGUMENT

Petitioner, a professional money management firm, invested in the common stock of Charter Communications, Inc. On behalf of a shareholder class, petitioner sued Charter for, *inter alia*, "entering into sham transactions with two equipment vendors that improperly inflated Charter's reported operating revenues and cash flow." *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 989 (8th Cir. 2006). Petitioner also sued the equipment vendors—respondents in this Court—for taking part in this "scheme." Petitioner alleged that respondents "entered into these sham transactions knowing that Charter intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations." *Id.* at 990. Respondents, however, "did not issue any misstatement relied on by the investing public, nor were they under any duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." *Id.* at 992.

In *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), this Court held that there is no liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), for "aiding and abetting" a fraudulent act—*i.e.*, only "primary" violators can be sued under that statute and its implementing regulation, Rule 10b-5, 17 C.F.R. § 240.10b-5. Congress quickly amended the Exchange Act to clarify that the SEC has enforcement authority over aiders and abettors, whom it defined as those

who "knowingly provide[] substantial assistance to another person in violation of [the Act]," 15 U.S.C. § 78t(e), but withheld that authority from private class-action plaintiffs. In this case, the lower courts correctly concluded that respondents are secondary actors subject to the enforcement authority of the SEC, but against whom there is no private right of action under the rule of *Central Bank*. *See* 443 F.3d at 992-93.

Petitioner's core contention is that respondents should have been categorized as primary violators under Section 10(b), and thus subject to liability in a private suit notwithstanding *Central Bank*, because they allegedly participated in a "scheme" to defraud Charter's shareholders. Although petitioner fails to articulate the contours of this theory of scheme liability, it apparently would encompass at least those entities that knowingly engage in "transactions with a public corporation . . . that enable[] the publication of artificially inflated financial statements by the public corporation," even though the entities themselves did not trade in the public company's stock, owed no duty to investors, and "made no public statements concerning those transactions." Pet. Br. i. *Amici* respectfully submit that knowingly "enabl[ing]" a public company's commission of an alleged fraud in this manner is a classic description of *secondary* liability. Accordingly, petitioner cannot maintain a class action against respondents under Section 10(b) and Rule 10b-5.

I. Both the text of Section 10(b) and the structure of the Exchange Act preclude judicial implication of a private right of action against a non-trading, non-speaking entity that merely "enables" the commission of an alleged fraud by a public company on its shareholders.

A. Petitioner's "scheme liability" theory is simply a semantic ploy designed to recast secondary conduct as a primary violation. The conduct at issue in *Central Bank* fits squarely within petitioner's definition of "scheme liability," but this Court has already held such conduct to be *secondary* to a primary violation and, thus, not actionable under Section 10(b). Mere knowing participation in another's alleged fraud

is not sufficient for liability to attach under that provision, as *Central Bank* makes clear, and petitioner has not alleged that respondents did anything more than that.

Following *Central Bank*, the SEC sought and received congressional clarification that it may proceed against persons, described as "aiders and abettors," who knowingly provide substantial assistance to a person who commits a primary violation. Petitioner's claim is that respondents knowingly provided substantial assistance to Charter, and thus respondents would be subject to the SEC's enforcement authority. But Congress did not confer equivalent authority on private plaintiffs; to the contrary, Congress has twice considered, but rejected, pleas to allow private claims against secondary actors. The Court should not do by fiat that which Congress has expressly declined to do by legislation.

B. No express provision in any of the federal securities laws allows investors to sue a non-speaking entity that did not transact in the issuer's securities and owed no duty to investors. Since Congress has never expressly authorized such a private suit, there is no reason to assume that Congress implicitly did so in Section 10(b). This Court has consistently resisted expansive readings of the judicially implied private right of action under Section 10(b). There is no warrant here to recognize a liability theory that Congress has not previously made available to private plaintiffs under the securities laws.

II. Policy considerations cannot override the text and structure of the Exchange Act unless they show that adherence to the statutory framework would lead to results so bizarre that Congress could not have intended them. The policy arguments advanced by petitioner and its *amici* fall far short of that standard.

A. Petitioner and its *amici* suggest that the private right of action under Rule 10b-5 ought to be extended to cover secondary actors to promote the policy goal of investor compensation. But there is a broad consensus in the academic community that the out-of-pocket measure of damages used

in Rule 10b-5 class actions challenging aftermarket fraud is economically irrational, because it bears little relation to the actual net harm suffered by investors. The wisdom of extending the current Rule 10b-5 remedial scheme is therefore far from obvious, particularly since the money paid to settle Rule 10b-5 class actions is most often funded by other innocent investors (and at considerable transaction costs). Furthermore, the SEC can now itself provide investors with meaningful compensation pursuant to its authority under the "Fair Funds" provision in the Sarbanes-Oxley Act of 2002.

B. The deterrence justification for judicially implying a private right of action premised on "scheme liability" is also dubious, since substantial deterrents already exist. The SEC and Department of Justice already can pursue claims against aiders and abettors, and none of the briefs submitted by petitioner and its *amici* demonstrates that additional deterrence is necessary or appropriate at the margins. Moreover, private "scheme liability" would give rise to substantial costs that might exceed its questionable deterrent benefits. Because the concept of "scheme liability" is not susceptible of precise definition, defendants faced with scheme liability claims may feel compelled to settle rather than risk expensive and protracted litigation. In addition, a defendant charged with scheme liability often will face damages exposure greatly in excess of the value of the transaction alleged to be part of the scheme. The risk of such liability would factor into the price of such transactions *ex ante*, raising the costs of doing business for companies listed on the U.S. markets. It could also stifle innovation in derivative transactions and other financial products.

III. Whether to create a new private right of action—or to extend an existing one—is a question appropriately directed to Congress, not this Court. Congress thus far has seen fit to give the SEC authority to pursue those who provide substantial assistance to primary violators of the securities laws, while withholding similar authority from private plaintiffs. If Congress were to consider expanding the private right, it would have to take into account a number of

competing policy considerations, including the impact of such an expansion on efficiency, competition and capital formation. It would also have to consider the proper parameters of scheme liability, including whether to provide safe harbors for derivative or other transactions. At the end of the legislative process, Congress might decide—as it has twice before—that the marginal costs of extending the private right to cover secondary actors would exceed the marginal benefits of such an extension, or it might decide that such an extension is warranted. But the very fact that a legislature could reasonably reach either conclusion demonstrates that the decision is not one for the Judiciary in the first instance.

ARGUMENT

Recognition of a private cause of action under Section 10(b) against non-trading, non-speaking entities that allegedly do no more than knowingly "enable[]" fraud by a public company (Pet. Br. i) is precluded by the text and structure of the Exchange Act. The policy arguments advanced by petitioner and its *amici* do not warrant deviation from that text and structure; to the contrary, considerations of legal and economic policy cast considerable doubt on the wisdom of allowing private suits like petitioner's. Those doubts should be resolved by Congress, not this Court.

I. The Text And Structure Of The Exchange Act Preclude Imposition Of Scheme Liability In Private Rule 10b-5 Actions

To determine whether a private plaintiff's claim may proceed under Rule 10b-5, this Court has employed a two-step statutory analysis. *First*, "the text of the statute controls" with respect to the "conduct prohibited by § 10(b)." *Central Bank*, 511 U.S. at 173. *Second*, "[w]hen the text of § 10(b) does not resolve a particular issue, [the Court] attempt[s] to infer how the 1934 Congress would have addressed the issue." *Id.* at 178 (internal quotation marks omitted). Both steps of the statutory analysis compel affirmance in this case.

A. Scheme Liability Is Inconsistent With Section 10(b), As Construed In *Central Bank*

Petitioner's attempt to hold non-trading, non-speaking entities such as respondents liable in an implied private action under Section 10(b) founders on the language of the statute itself. The analysis in this regard can be boiled down to two incontrovertible events: This Court's decision in *Central Bank*, and the congressional response to that decision.

1. Central Bank served as indenture trustee for bonds issued subject to a covenant that they be secured by real estate worth at least 160% of the bonds' outstanding principal and interest. *Central Bank*, 511 U.S. at 167. The bank was "aware of concerns" regarding the value of the security, in particular "the accuracy of the [pre-existing] appraisal." *Id.* at 168. A senior underwriter of the bond warned the bank that the appraisal, which was then more than 16 months old, "'should be suspect and not relied on'" in light of declining real-estate values. *First Interstate Bank of Denver, N.A.* v. *Pring*, 969 F.2d 891, 894 n.5 (10th Cir. 1992). And the bank's own in-house appraiser expressed concern about the values used in the appraisal. 511 U.S. at 167. Despite these warnings, Central Bank acceded to the bond issuer's request to delay an independent appraisal by six months, during which time the issuer defaulted on a new issuance that, the plaintiff alleged, would not have come to market absent Central Bank's agreement to defer the new appraisal. *Id.* at 167-68.

This Court concluded that Central Bank's conduct was beyond the proscriptive reach of Section 10(b). Central Bank, itself, "did not commit a manipulative or deceptive act within the meaning of § 10(b)," as the plaintiffs there had to concede. 511 U.S. at 191. Instead, Central Bank would have had to be found "'secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud'" committed by the issuer. *Ibid.* This Court concluded, however, that Section 10(b) reaches only *primary* violators. *Ibid.* It therefore held that the suit against Central Bank had properly been dismissed by the district court. *Id.* at 191-92.

As a comparison with the facts of *Central Bank* makes clear, petitioner's "scheme liability" theory is simply a semantic ploy designed to recast secondary conduct as a primary violation. The conduct at issue in *Central Bank* would fit *squarely* within the definition of "scheme liability" that petitioner proposes in this case (Pet. Br. i): Central Bank engaged in a transaction with the issuer (*i.e.*, an agreement to defer the new appraisal) that "enabled" the issuer to publish false statements (*i.e.*, that the security covenant was satisfied), although the bank itself made no statement directly to the bondholders. It follows *a fortiori* from *Central Bank* that respondents here, who owed no duty to Charter's shareholders and did not engage in any public misrepresentations (or public deceptive acts), also did not engage in a primary violation (regardless of whether they "enable[d]" Charter's allegedly fraudulent scheme). *See Chiarella* v. *United States*, 445 U.S. 222, 233 (1980) (declining, in the absence of "explicit evidence of congressional intent," to "recogniz[e] a general duty between all participants in the market" to refrain from any act that may contribute to harm to other market participants).

Indeed, one of the central elements of the implied private Rule 10b-5 action is the plaintiff's *reliance* on the defendant's alleged wrongdoing. *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 341 (2005). But petitioner, the plaintiff here, cannot establish reliance on respondents' alleged wrongdoing, either directly or by use of the fraud-on-the-market presumption: Again, respondents made *no* public misrepresentations and engaged in *no* public deceptive acts (*cf. Basic Inc.* v. *Levinson*, 485 U.S. 224, 243 (1988)); moreover, given their lack of duty, respondents cannot be charged with an actionable omission (*cf. Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972)). Allowing a defendant to be held "liable without any showing that the plaintiff relied upon [defendant's] *statements* or *actions*" would "circumvent the reliance requirement [and] would disregard the careful limits on 10b-5 recovery mandated by . . . earlier cases." *Central Bank*, 511 U.S. at 180 (emphasis added); *see also id.* at 191 (describing a primarily liable party as one "who employs a

manipulative device or makes a material misstatement (or omission) *on which a purchaser or seller of securities relies*") (emphasis added); *cf.* Roberta S. Karmel, *When Should Investor Reliance Be Presumed In Securities Class Actions?*, Brooklyn Law School Legal Studies Research Papers: Accepted Papers Series, Research Paper No. 80 at 39 (forthcoming in BUSINESS LAWYER 2007), *available at* http://ssrn.com/abstract=1001743 (observing that "extending the fraud-on-the-market doctrine to statements by third parties, who are not required to speak by SEC regulations, or do not owe a duty to investors or shareholders" would be unwise, as it could "encourage too much questionable litigation").

As the Court put it in *Central Bank*, "[t]he proscription" of Section 10(b) "does not include giving aid to a person who commits a manipulative or deceptive act." 511 U.S. at 177. *Central Bank* itself recognized that knowing participation in a "scheme" is simply another label for aiding and abetting when it analogized an aiding-and-abetting claim under the securities laws to a claim for "knowing *participation* in a breach of fiduciary duty" under ERISA, and the Court rejected both under the text of the applicable statutes. *Id.* at 175, 176 (emphasis added); *see also* Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 105-06 & n. 138 (1981) (arguing that knowingly assisting another's deceptive act does not violate Section 10(b)). Petitioner has not alleged that respondents did anything more than knowingly participate *in Charter's* alleged fraud; this is a secondary violation in every sense of the word.[2]

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[2] Contrary to the suggestion of petitioner's amici (Br. for Charles W. Adams, et al. 3), interpreting the scope of Section 10(b) in accordance with its text would not allow the villain Fagin, from *Oliver Twist*, to escape liability under the Ex-

[Footnote continued on next page]

2. In the wake of *Central Bank*, the SEC lobbied Congress for clarification that it may pursue secondary actors. Congress responded not by amending Section 10(b), but by enacting a new Section 20(e), which provides:

> **Prosecutions of Persons Who Aid and Abet Violations**. For purposes of any action brought by the Commission . . . , any person that *knowingly provides substantial assistance* to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

15 U.S.C. § 78t(e) (emphasis added).

Thus, if there were any question after *Central Bank* that aiding and abetting liability includes "scheme liability," Congress laid it to rest by *defining* aiding and abetting liability, for purposes of SEC enforcement actions, to include precisely that: Petitioner's claim, at bottom, is that respondents *knowingly provided substantial assistance* to Charter's alleged fraud. But Congress consciously decided, both when it enacted Section 20(e) in 1995 and again when it enacted Sarbanes-Oxley in 2002—*not* to extend the right to enforce this liability to private plaintiffs. *See* S. Rep. No. 104-98, at 48 (1995) ("The Committee believes that amending the 1934 Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to S. 240's goal of reducing meritless securities litigation"); H.R. Rep. No. 107-414, at 54 (2002); 148 Cong. Rec. S6584 (daily ed. July 10, 2002). This Court should not do, by fiat, that

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[Footnote continued from previous page]

change Act. *See* 15 U.S.C. § 78t(a) (imposing control person liability).

which the Congress has declined to do each time it has been presented with the issue.

B. No Express Private Right Of Action Recognizes Scheme Liability

Central Bank and the congressional reaction to that decision make clear enough that Section 10(b) does not encompass scheme liability. The express private rights of action that Congress chose to include in the Exchange Act only serve to confirm that conclusion. No express provision in any of the federal securities laws allows investors to sue a non-speaking entity that did not transact in the issuer's securities and owed no duty to investors. Since Congress has never expressly endorsed petitioner's theory of "scheme liability," it makes no sense to assume that Congress implicitly did so for private Rule 10b-5 actions.[3]

The Court's conclusion in *Central Bank* is equally applicable here: "From the fact that Congress did not attach private aiding and abetting liability to any of the express causes of action in the securities Acts, we can infer that Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action." 511 U.S. at 179. By parity of reasoning, the fact that Congress has never seen fit to allow a private action premised on "scheme liability" compels the inference that Congress would not have authorized such liability in private Rule 10b-5 actions. That inference is confirmed by the post-*Central Bank* actions (and inactions) by Congress described in the preceding section.

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[3] This is not to suggest that an entity that does speak, breach a duty or transact in the issuer's securities is necessarily liable under Rule 10b-5. *See Dura Pharms., Inc.*, 544 U.S. at 341 (listing the elements necessary to establish a private Rule 10b-5 claim).

The implied right of action under Rule 10b-5 is of judicial creation. This Court has repeatedly resisted expansive readings of the implied right, recognizing that private securities litigation is susceptible to abuse. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 736 (1975) ("It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action"); *Dura*, 544 U.S. at 347 (rejecting plaintiffs' claim that loss causation need not be alleged with specificity based on concerns about "'abusive' practices"). There is simply no warrant for the Court to adopt, or invent, a liability theory that Congress has never expressly afforded to private plaintiffs under the federal securities laws. *Cf.* David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision Of Legislative Intent?*, 57 NW. U. L. REV. 627, 660 (1962) (because it is implied, the private right under Rule 10b-5 "should be interpreted with caution").

II. The Policy Arguments Advanced By Petitioner And Its *Amici* Do Not Justify Deviation From The Text And Structure Of The Exchange Act

Petitioner and some of its *amici* suggest that private Rule 10b-5 liability ought to be extended to encompass "scheme liability" in order to ensure investor compensation and adequate deterrence. But such "[p]olicy considerations cannot override [this Court's] interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." *Central Bank*, 511 U.S. at 188. The arguments advanced by petitioner and its *amici* fall far short of that standard.

A. Compensation

Petitioner and its *amici* urge this Court to characterize those who merely "enable" another's fraud as primary violators in order to promote the goal of investor compensation. But a broad consensus in the academic community recognizes that the out-of-pocket measure of damages utilized in

Rule 10b-5 class actions challenging aftermarket fraud is economically irrational. Innocent investors, rather than the actual wrongdoers, most often fund the recovery in Rule 10b-5 class actions. Given that diversified investors are unlikely, over time, to suffer net harm from aftermarket securities fraud, this very expensive system of investor self-insurance is difficult to defend from a compensatory standpoint. The wisdom of extending it to cover "scheme liability" claims is therefore far from obvious.

1. Almost without exception, Rule 10b-5 class actions that are not dismissed at the pleading stage result in settlement, and the individual wrongdoers allegedly responsible for the fraud rarely contribute. *See* John C. Coffee, Jr., *Reforming The Securities Class Action: An Essay On Deterrence And Its Implementation*, 106 COLUM. L. REV. 1534, 1550-51 (2006). Instead, the primary sources of settlement payments are issuers, their insurers, and ancillary defendants. *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1506 & n. 81 (1996). Each of these sources of funds may be traced back to innocent investors: Payments by the issuer effect a direct transfer of wealth from the issuer's current shareholders to the class members; payments by insurers are funded by premiums paid by the insurer's policyholders (issuers and, indirectly, their innocent shareholders); and payments by ancillary defendants, like accountants and investment banks, may be charged back to issuers (and, indirectly, their innocent shareholders) through increased fees due to litigation risk. *See* Donald C. Langevoort, *Capping Damages For Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 649 (1996). Moreover, ancillary defendants may themselves be publicly-owned companies, thus implicating yet another group of innocent investors.

As a result, the amount that some investors gain from private Rule 10b-5 class actions "will show up on the other side of the capital marketplace ledger as roughly an equal charge to other[]" innocent investors. Langevoort, 38 ARIZ. L. REV. at 649. Rule 10b-5 class actions are therefore like a

very inefficient form of investor self-insurance—one that, as explained below, diversified investors do not need. *See* INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at 79 (2006) (the transfer from diversified investors to other diversified investors "represents a pocket-shifting wealth transfer that compensates no one in any meaningful sense and that incurs substantial wasteful transaction costs in the process").

2. The loss suffered by an investor who purchased securities at an artificially inflated price is always matched with a corresponding gain to the investor on the other side of the transaction—thus, in a case of aftermarket fraud, innocent investors earn a profit by selling their stock at a price inflated by the fraud, and the law allows them to keep their profits. Because it can be assumed that an innocent investor's chance of being on the losing or winning side of such a transaction is random, a well-diversified investor's gains and losses from aftermarket securities fraud will tend to net out over time.[4]

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[4] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339-341 (1991); Richard A. Epstein, CASES AND MATERIALS ON TORTS, 8th edition, 1124 n.4 (Aspen 2004); Stephen J. Choi & A.C. Pritchard, SECURITIES REGULATION: CASES AND ANALYSIS at 348 (2005); James D. Cox, Robert W. Hillman, & Donald C. Langevoort, SECURITIES REGULATION: CASES AND MATERIALS 727-728 (5th ed. 2006); Larry E. Ribstein, *Dabit, Preemption and Choice of Law*, 2006 CATO SUPREME COURT REVIEW 141, 147-152; Richard A. Booth, *Who Should Recover What For Securities Fraud?*, University of Maryland School of Law Legal Studies Research Paper, No. 2005-32 (2005) at 6, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=683197; Anjan V. Thakor, *The Economic Reality of Securities Class Action Litigation* at 1 (Navigant Consulting 2005), *available at* http://downloads.heartland.org/18331.pdf; Janet Cooper Alexander, *Rethinking*

[Footnote continued on next page]

Such an investor would "perceive[] little good in a legal rule that forces his winning self to compensate his losing self over and over," while paying substantial legal fees to boot. Easterbrook & Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 340; *see also* Coffee, 106 COLUM. L. REV. at 1537 (observing that "the burden of securities [litigation] falls perversely on the victim," which may explain "stock price event studies that report that the subject company's stock price typically falls when a securities class action is filed and that stock prices generally rise when legislation is passed curtailing securities class actions"); Alexander, 48 STAN. L. REV. at 1502 ("the risk of litigation, unlike the risk of securities fraud, cannot be diversified against because the legal fees of both sides constitute a deadweight loss").

This is not to say that aftermarket securities fraud causes no harm to investors. But extending the remedy of out-of-pocket compensatory damages to reach secondary violators in aftermarket fraud cases, such as this one, is not the best method for redressing that harm. *Cf.* Langevoort, 38 ARIZ. L. REV. at 651 (the compensatory justification for private Rule 10b-5 actions "has relatively few informed, non self-serving defenders"); Coffee, 106 COLUM. L. REV. at 1545 ("From a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly"); A.C. Pritchard, *Who Cares?*, 80 WASH. U. L.Q. 883, 884 (2002) ("Securities class actions cannot be justified as providing compensation"). This is particularly true now that the SEC is authorized to play an important role in providing compensation to investors through the "Fair Funds" provision in the Sarbanes-Oxley Act of 2002. *See infra* at 18.

[Footnote continued from previous page]

Damages in Securities Class Actions, 48 STAN. L. REV. 1487, 1495-1496 (1996).

B. Deterrence

The deterrence-based policy arguments raised by petitioner and its *amici* similarly fail to demonstrate that adhering to the text and structure of the Exchange Act would lead to a "'bizarre'" result. *Central Bank*, 511 U.S. at 188. Those who assist another's primary violation of Rule 10b-5 *already* face significant sanctions at the hands of public enforcers; it is therefore far from clear whether the additional marginal deterrence that might result if private "scheme liability" were recognized is even necessary. Nor is it clear whether the benefits of this additional deterrence, if any, would exceed the costs of expanding the scope of the implied right.

1. Those who aid and abet securities law violations face considerable deterrents under the existing regime. The Department of Justice, for example, can bring criminal charges against those who aid and abet a securities law violation. *See* 18 U.S.C. § 2. As noted above, Congress has also conferred authority on the SEC to pursue aiders and abettors, 15 U.S.C. § 78t(e)—authority the SEC has utilized to pursue allegations *identical to those in this case*. *See* SEC Release No. 19735, SEC v. Scientific-Atlanta, Inc., Civ. Action No. 06 Civ. 4823 (PKC) (June 22, 2006), *available at* http://www.sec.gov-/litigation/litreleases/2006/lr19735.htm; *see also* PRICEWATERHOUSECOOPERS LLP 2006 SECURITIES LITIGATION STUDY at 24-25, *available at* http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf (detailing public enforcement efforts in 2006).

The SEC has utilized its enforcement authority in recent years to recover substantial penalties from securities law violators, money it has returned in large part to injured investors pursuant to the Fair Funds provision in the Sarbanes-Oxley Act of 2002. 15 U.S.C. § 7246; *see also* 17 C.F.R. §§ 201.1100-201.1106. Indeed, the SEC has collected at least $8 billion for distribution to harmed investors since 2002. *See* 2006 PERFORMANCE AND ACCOUNTABILITY REPORT, U.S. Securities and Exchange Commission, *available at* http://www.sec.gov/about/secpar/secpar2006.pdf. It recently reported that it has returned over $1 billion to inves-

tors since 2005. *See Hearing: A Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission Before the House Comm. on Financial Services*, 110th Cong., 1st Session (June 26, 2007) (Statement of the Securities and Exchange Commission) (noting that "[s]everal additional large disbursements are pending and will be announced shortly").

In addition to financial penalties, the SEC has available to it a panoply of remedies that enable it to perform its deterrent function in a finely calibrated manner, depending on the facts and circumstances of the particular case before it. These remedies, the availability of which vary somewhat depending on whether the Commission initiates an administrative proceeding or files suit directly in federal court, today include: officer and director bars; injunctive relief; cease and desist orders; disgorgement of ill-gotten gains; and orders requiring corrective disclosures and corporate governance changes, among other things. *See* Vincent J. Badolato, SECURITIES LAW TECHNIQUES §§ 87.06-87.07 (Matthew Bender 2006). Importantly, the SEC and DOJ can impose career- and liberty-ending sanctions on individuals involved in fraudulent activity. Public enforcement serves as a stronger deterrent in this regard than private enforcement, as individuals are rarely made to contribute to the settlement of Rule 10b-5 class actions. *See* Coffee, 106 COLUM. L. REV. at 1550-51.[5]

In light of the amount of deterrence that already exists, it is far from clear that the additional *marginal* deterrence that might result from implying private "scheme liability" is even necessary. *See* INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at 78 ("the public value of

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[5] The Sarbanes-Oxley Act of 2002 further protects against fraud by, *inter alia*, imposing potential civil and criminal liability for the false certification of the adequacy of internal controls. *See* 15 U.S.C. § 7241; 18 U.S.C. § 1350.

the securities class action is questionable"). Nor, as discussed below, is it clearly desirable. *Cf.* Eric L. Talley, *Cataclysmic Liability Risk Among Big Four Auditors*, 106 COLUM. L. REV. 1641, 1642 (2006) ("Auditors now face enhanced vulnerability to liability risks that—at least according to some—threaten the very viability of the industry as we know it").

2. It is not clear that the potential marginal benefits of Rule 10b-5 "scheme liability" class actions would exceed their marginal costs, and petitioner and its *amici* have made no such showing. More enforcement is not an unmitigated good. To the contrary, "[i]f there is excessive securities litigation, too many resources will be spent on litigation and on litigation avoidance. The cost of capital will then increase just as if a wasteful tax had been imposed on capital formation." Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 732 (1995) (emphasis omitted). When liability rules are unclear, the risk of overenforcement, and overdeterrence, is particularly acute. In recognition of this, the bipartisan Committee on Capital Markets Regulation recently advised that "there needs to be greater clarity to private litigation under Rule 10b-5." INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION at xii. It recommended that the SEC provide more guidance on such things as materiality, scienter, and reliance, to help ensure that the U.S. capital markets stay competitive in the global economy. *Id.* at 80-82.

Were this Court to recognize petitioner's theory of "scheme liability," it would inject confusion, not clarity, into private litigation under Rule 10b-5. Not even proponents of "scheme liability" can consistently define this amorphous concept.[6] Given this uncertainty, and the magnitude of the

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[6] Compare Br. of the SEC at 18, *Simpson* v. *AOL Time Warner, Inc.*, No. 04-55665 (9th Cir. Oct. 22, 2004) (defendant must "engag[e] in a transaction whose principal purpose

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potential damage awards, defendants in private Rule 10b-5 "scheme liability" cases might "find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." *Central Bank*, 511 U.S. at 189.

Those involved in derivative securities transactions might face a particularly strong pressure to settle, given that such transactions commonly raise complex accounting, taxation, and reporting issues. In light of these complexities, there exists a material probability that courts would allow class action fraud claims predicated on derivative markets transactions to move past the motion to dismiss stage, even though the impropriety of the transaction may be subject to considerable doubt—transactions that seem entirely legal to one impartial fact-finder may seem problematic to another fact-finder considering precisely the same facts. *See gener-*

[Footnote continued from previous page]

and effect is to create a false appearance of revenues") with *Simpson* v. *AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), *petition for cert. filed* (Oct. 19, 2006) (No. 06-560) ("defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme"; rejecting SEC's suggestion that it is sufficient "that a *transaction* in which a defendant was involved had a deceptive purpose and effect") (emphasis in original); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 502-04 (S.D.N.Y. 2005) (defendant must have "directly or indirectly used or employed any device or contrivance with the capacity or tendency to deceive"; rejecting *Lernout's* requirement of "substantial participation" as inconsistent with Section 10(b)'s text); and *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) (defendant must have "substantially participate[d] in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device . . . intended to mislead investors").

ally Joseph A. Grundfest, *Scheme Liability: A Question for Congress, Not for the Courts*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005524 at 14-15.

In this regard, it is illustrative to compare the British High Court's decision in *Mahonia Limited* v. *JP Morgan Chase Bank, West LB AG*, 2004 WL 1808816 (Q.B.D. (Comm. Ct.)) (Aug. 3, 2004), with the Commission's enforcement action in *SEC* v. *J.P. Morgan Chase & Co.*, No. H-03-28-77 (S.D. Tex.). Both actions involved a series of complex derivative transactions called "prepays." The SEC alleged that these transactions "had no business purpose aside from masking the fact that, in substance, they were loans and not swap contracts," and should therefore have been accounted for as loans. *J.P. Morgan* Compl. ¶1. The swap counterparty (Chase) was alleged by the SEC to be liable as an aider and abettor to securities fraud.[7] In stark contrast, the British High Court, having considered precisely the same transactions, concluded (at ¶236) that the "accounting for the prepays was not in breach of US GAAP [and] that its accounting for these transactions did not constitute a breach of US securities law." The British High Court further concluded that "[e]ven if there had been a breach of US GAAP," it "would not have found that there was any aiding and abetting by Chase." *Id.* ¶240. Evidently, objective observers of good faith can have differing views regarding the proper accounting for a derivative markets transaction.

In addition to prompting defendants to settle defensible cases and incentivizing plaintiffs to file questionable claims, recognizing private "scheme liability" would give rise to other costs. "Scheme liability" would expose those engaging in commercial transactions with public companies to disproportionate damages orders of magnitude greater than the size of the transaction alleged to give rise to the liability, and for

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[7] Chase settled the matter with the SEC, without admitting or denying the allegations in the complaint.

misstatements or omissions that they, themselves, did not make.[8] This would encourage such parties to spend resources monitoring the adequacy of their public counterparty's disclosures. These additional costs and the residual risk of liability would likely be priced into those transactions *ex ante*, burdening companies listed on the U.S. markets—and, ultimately, their investors and customers.

Start-up and technology companies might feel the brunt of these increased costs in their dealings with suppliers and creditors, given that their volatile stock prices make them—and those who deal with them—the most likely targets of securities fraud class actions. Moreover, innovation in the financial services area might be stifled for fear that new types of transactions would be labeled as "deceptive," and subject a financial institution to huge liabilities. Indeed, if "scheme liability" were recognized, particularly without transactional safe harbor provisions of the sort that could be created only by Congress, the implications for derivative trading, and its continued presence in U.S. markets subject to U.S. prosecution, may be profound. It is not obvious that the additional monitoring of public company disclosures that scheme liability might prompt would create benefits in excess of these costs.

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[8] In this case, for example, the total market capitalization loss upon disclosure of a criminal investigation into Charter's practices was $7 billion. The amount of alleged inflation attributable to respondents' transactions with Charter, by contrast, was only $17 million. *See also* Second Am. Consol. Class Action Compl. ¶¶ 9, 25, *In re Fannie Mae Sec. Litig.*, MDL No. 1688 (D.D.C.) (alleging that Goldman Sachs violated Rule 10b-5(a) and (c) by "engineering" two transactions that Fannie Mae purportedly accounted for erroneously, and seeking to hold Goldman Sachs liable for Fannie Mae's $12 billion loss of market capitalization even though its involvement affected less than 1% of the alleged stock price inflation).

This Court recognized the potential for these types of "ripple effects" in *Central Bank*. 511 U.S. at 189. It explained that interpreting Section 10(b) to encompass aiding and abetting liability would "exact[] costs that may disserve the goals of fair dealing and efficiency in the securities markets." *Id.* at 188. The Court declined to do so, based in part on the fact that "the rules for determining aiding and abetting liability are unclear, in 'an area that demands certainty and predictability.'" *Ibid.* Uncertain risk of liability might cause securities professionals to refuse to provide services to some companies altogether, this Court explained, and might cause them to increase the prices charged to others (prices "in turn [paid] by the company's investors, the intended beneficiaries of the statute"). *Id.* at 189.

A similar sentiment influenced this Court's recent decision in *Credit Suisse Securities (USA) LLC* v. *Billing*, 127 S. Ct. 2383 (2007). The Court took as a given that the conduct alleged in that case had been disapproved by the SEC, but nonetheless observed that serious harm could come of subjecting that conduct to private attack under the antitrust laws. The Court explained that "only a fine, complex, detailed line separates activity" that the SEC permits and forbids, and that "[i]n light of the nuanced nature of the evidentiary evaluations necessary to separate the permissible from the impermissible, it will prove difficult for . . . different courts to reach consistent results." *Id.* at 2394, 2395. Thus, allowing private antitrust suits to proceed would likely "overly deter syndicate practices important in the marketing of new issues." *Id.* at 2397. Decisions such as *Central Bank* and *Billing* confirm the wisdom of leaving the difficult policy question whether to expand the private right of action under Rule 10b-5 to include "scheme liability" to Congress.

III. Creating A Private Right Of Action Is A Job For Congress, Not This Court

The days of judicially-implied private rights of action are long past. *Alexander* v. *Sandoval*, 532 U.S. 275, 287 (2001); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 18-19 (1979). Under the modern regime, the deci-

sion to create a new cause of action—or, equivalently, to extend an existing right of action—lies squarely with Congress, not the courts. *Sandoval*, 532 U.S. at 288. This Court recently reiterated as much in the context of the very statute at issue in this case. *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, No. 06-484, 551 U.S. __, slip op. at 15-16 (June 21, 2007) ("It is the federal lawmaker's prerogative . . . to allow, disallow, or shape the contours of—including the pleading and proof requirements for—§ 10(b) private actions"). Congress chose to leave it to the SEC alone to enforce scheme liability. If petitioner and its *amici* believe that an expansion of private securities litigation is advisable—in light of the changes wrought by the PSLRA, or to better incentivize gatekeepers to police for fraud, or for any of the other various policy reasons set forth in the briefs in this case—they should direct their proposals to Congress, not this Court.

In deciding whether to create a private right of action premised on "scheme liability," Congress would have to determine whether the marginal benefits of doing so would exceed the marginal costs. As explained above, that would require the weighing of several difficult policy considerations. To aid in that process, Congress could hear witnesses, request studies, and otherwise examine the empirical evidence to predict the likely consequences of recognizing scheme liability for capital formation, market efficiency, and consumer welfare. If nothing else, the process would make a record that would assist the Court in construing any resulting legislation. *Cf. Tellabs*, 551 U.S. __, slip op. at 10 (noting PSLRA's "twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims").

Congress would also have to consider how "scheme liability" should be defined, something neither the SEC (in its enforcement capacity) nor the lower courts have been able to agree on. *See* note 6, *supra*. It might also consider whether to offer certain safe harbors to ensure that beneficial derivative transactions meant to hedge risks for investors are not unnecessarily deterred. *See generally* Grundfest, *Scheme Li-*

ability: A Question for Congress, Not for the Courts, *supra*, at 6-7. Or it might simply extend the Commission's existing power under Section 20(e) to private plaintiffs. Of course, that Congress has thus far chosen *not* to do so only reinforces the wisdom of leaving this decision to Congress in the first instance.

A responsible legislature would weigh these and similar policy considerations before deciding to expand the private right of action under Rule 10b-5 to encompass non-trading, non-speaking entities such as respondents. *See, e.g.*, S. Rep. No. 104-98, at 48 (noting risks of meritless litigation raised by private aiding-and-abetting liability). It could be that, at the end of the legislative process, Congress would make the political judgment that the benefits of a private "scheme liability" regime would outweigh its costs. It could also be, however, that Congress would determine that the marginal benefits of recognizing private scheme liability, if any, are far outweighed by the costs of such liability. The very fact that the legislature could reasonably come out on either side of this policy debate—a point that petitioner cannot dispute—is sufficient to demonstrate that it is, at bottom, a legislative decision, not a judicial one.

Most lower courts have properly recognized the limitations on the Judiciary's power to create or extend private rights of action, and thus have refused to recognize "scheme liability."[9] This majority view reflects a general consensus among federal judges that, if scheme liability is to be recog-

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[9] *Charter*, 443 F.3d at 989; *Regents of the Univ. of Cal.* v. *Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *petition for cert. filed* (Apr. 5, 2007) (No. 06-1341); *Fidel* v. *Farley*, 392 F.3d 220, 235 (6th Cir. 2004); *Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1213 (11th Cir. 2001); *Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter* v. *Home-Stake Prods. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996).

nized at all, it should be done in the first instance by Congress: Imposing liability for securities fraud based on transactions "in goods or services other than securities . . . would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress." *Charter*, 443 F.3d at 992-93.

* * *

It has been observed that "[t]his is one of the most important securities cases to be heard by this Court in many years." Br. for William H. Donaldson, et al. 2. On this point, *amici* joining this brief are in agreement. This *is* an important case. It is important because it gives the Court the opportunity to reconfirm that the securities laws mean what they say, *Tellabs*, 551 U.S. __, slip op. at 12; that the securities laws should be construed to further market efficiency, *Billing*, 127 S. Ct. at 2396; and that pure policy decisions are for Congress in the first instance, *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976). The Court's decision in *Central Bank* reflects each of those principles. Adherence to them requires affirmance of the judgment below. Departure, by contrast, would "re-open a plethora of doctrinal issues regarding the interpretation of the federal securities laws that are today clearly resolved." Grundfest, *Scheme Liability: A Question for Congress, Not for the Courts*, *supra*, at 3-4.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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IN THE

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STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

—v.—

SCIENTIFIC-ATLANTA, INC., *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE LOS ANGELES COUNTY EMPLOYEES RETIREMENT ASSOCIATION, NEW YORK CITY BOARD OF EDUCATION RETIREMENT SYSTEM, NEW YORK CITY EMPLOYEES' RETIREMENT SYSTEM, NEW YORK CITY FIRE DEPARTMENT PENSION FUND, NEW YORK CITY POLICE PENSION FUND, NEW YORK CITY TEACHERS' RETIREMENT SYSTEM, CONNECTICUT RETIREMENT PLANS AND TRUST FUNDS, AND THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF AMICI CURIAE[1]

This brief is filed by public pension systems that invest billions of dollars in U.S. capital markets to fund obligations to their beneficiaries and, therefore, have a strong interest in the integrity of the securities markets and the elimination of fraud in such markets. These public pension funds believe that the scope of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), should be interpreted so as to achieve Congress's intention of eliminating deceptive practices in the purchase or sale of securities.

The Los Angeles County Employees Retirement Association ("LACERA") is the largest county retirement system in the United States, with 147,000 members and $35 billion in assets.

The New York City Employees' Retirement System ("NYCERS"), in existence since 1920 and one of the largest public pension funds in the United States, has a rich history of shareholder activism and *amicus* involvement in corporate governance issues. *See, e.g., New York City Employees' Retirement System v. S.E.C.*, 45 F.3d 7 (2d Cir. 1995); *New York City Employees' Retirement System v. Dole Food Co.*, 969 F.2d 1430 (2d Cir. 1992); *New York City Employees' Retirement System v. American Brands, Inc.*, 634 F. Supp. 1382 (S.D.N.Y. 1986). NYCERS is a public employee retirement system established pursuant to Section 130-102 of the Administrative Code of the City of New York that provides retirement, disability and death benefits to certain New York City

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[1] This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici* and their counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of this brief and copies of their consent have been lodged with the Clerk of the Court.

employees. NYCERS has over 300,000 active and retired participants and total plan assets of over $40 billion.

The New York City Board of Education Retirement System ("BERS") provides pension benefits to approximately 35,000 active and retired members, comprised mainly of non-pedagogical employees of the New York City Department of Education. Its plan assets exceed $2.3 billion.

The New York City Teachers' Retirement System ("TRS") provides a retirement program for some 150,000 active and retired participants who work, or have worked, for the New York City Department of Education, New York City Charter Schools or the City University of New York. TRS' basic qualified pension plan has some $40 billion in assets. In addition, the System administers a Section 403(b) tax-deferred annuity program, with more than $15 billion in assets.

The New York City Fire Department Pension Fund ("FDPF") is a single-employer public employee retirement system serving full-time uniformed employees of the New York City Fire Department. FDPF has approximately 11,500 active members and 15,700 retired members, including widows and beneficiaries. Its assets exceed $7 billion.

The New York City Police Pension Fund ("PPF"), in existence since 1857, was the first municipal retirement system established in the United States. It initially provided lump sum benefits for New York City policemen injured in the line of duty, and expanded some twenty years later to provide half pay retirement benefits to retired policemen. PPF currently administers benefits for approximately 74,000 active and retired members; the

plan assets, including variable supplement funds, are approximately $15 billion.

The Connecticut Retirement Plans and Trust Funds ("CRPTF") invests assets on behalf of public employees in the State of Connecticut. With over $20 billion in assets under management, CRPTF consists of six pension funds and eight trust funds, representing, among others, approximately 160,000 teachers, police officers, firefighters, and other state and municipal employees who are pension plan participants and beneficiaries.

The California Public Employees' Retirement System ("CalPERS") is the largest public pension fund in the United States. It manages pension and health benefits for more than 1.5 million California public employees, retirees, and their families. CalPERS manages over $247 billion in total investments.

In the aggregate, U.S. public pension plans cover more than 14 million workers and 6 million retirees and other beneficiaries and have assets of more than $2 trillion.[2]

The *amici*'s overriding responsibility is to invest for the long-term security of their millions of active and retired members. As major investors with long-term outlooks, the *amici* are vitally concerned with the proper and efficient functioning of U.S. capital markets, and are particularly concerned that investors not be harmed by fraudulent conduct. Many state and local governments are constitutionally obligated to guarantee defined benefit retirement plans. Therefore, investment losses due to securities fraud fall directly on state and local governments and ultimately on taxpayers. If public pension

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[2] *See* Gary W. Anderson & Keith Brainard, *Profitable Prudence: The Case for Public Employer Defined Benefit Pension Plans*, 1 (Pension Research Council Working Paper 2004-6, 2004), *available at* http://rider.wharton.upenn.edu/~prc/PRC/WP/WP2004-6.pdf.

funds are prevented from recovering money lost to securities fraud, the public will suffer.[3]

In recent years, public pension funds have become increasingly concerned about the integrity of U.S. securities markets. Scandals at Enron, WorldCom, Global Crossing, Tyco, Refco, Fannie Mae, Freddie Mac, Adelphia, Xerox, and numerous other public companies have caused hundreds of billions of dollars in losses to innocent investors. As investors who have been materially harmed by corporate fraud, *amici* have strong interests in ensuring that the law allows injured investors to recover from perpetrators of fraud.

The *amici* strongly believe that investors' ability to redress corporate wrongdoing through private actions under the Securities Exchange Act of 1934 is essential to deter improper conduct and to recoup losses caused by fraud. Indeed, with the Private Securities Litigation Reform Act ("PSLRA"), Congress sought "to increase the likelihood that institutional investors will serve as lead plaintiffs," based on its belief "that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Conf. Rep. 104-369, 1995 U.S.C.C.A.N. 730, 733. Following the passage of the PSLRA, *amici* here have served as lead plaintiffs in numerous cases, including *Leech v. Brooks Automation, Inc.*, No. 06-11068-RWZ, 2006 U.S. Dist. LEXIS 90153

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[3] In 2005, investment earnings accounted for 74 percent of all public pension plan revenue and employer (*i.e.*, taxpayer) contributions for only 17 percent. *See* National Association of State Retirement Administrators, *Key Facts Regarding State and Local Government Defined Benefit Retirement Plans*, (Jan. 2007), http://www.nasra.org/news/article.asp?newsid=112) (follow "Access the Key Facts document" hyperlink).

(D. Mass. Dec. 13, 2006) (LACERA); *In re JDS Uniphase Corp. Securities Litigation*, No. C 02-1486 CW, 2006 U.S. Dist. LEXIS 18872 (S.D. Cal. April 6, 2006) (CRPTF); *In re Enterasys Networks, Inc., Securities Litigation*, No. 02-071-M, 2002 U.S. Dist. LEXIS 15450 (D.N.H. Aug. 2, 2002) (LACERA); *In re Waste Management, Inc.*, 128 F. Supp. 2d 401 (S.D. Tex. 2000) (CRPTF); *In re Orbital Sciences Corp. Securities Litigation*, 187 F.R.D. 246 (E.D. Va. 1999) (BERS, NYCERS and FDPF); and *In re Cendant Corp. Litigation*, 182 F.R.D. 144 (D.N.J. 1998) (CalPERS).[4]

Before 1995, settlements for more than $20 million were unusual, and settlements of $100 million or more were exceedingly rare. Since 1995, seven cases have settled for more than $1 billion and more than 20 cases have settled for more than $100 million. Recoveries have reached unprecedented levels because of the cases' merit and institutional investor leadership.[5] At the same

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[4] The *amici*, as long term investors, also have an interest in preventing meritless, lawyer-driven litigation. As one of many ways the PSLRA discourages meritless cases, the statute's "professional plaintiff" provision bars a plaintiff from serving as lead plaintiff in more than five actions filed within three years, except as permitted by the court. *See* 15 U.S.C. § 78u-4(a)(3)(B)(vi). Notably, Congress gave courts discretion to allow "[i]nstitutional investors seeking to serve as lead plaintiff . . . to exceed this limitation [because they] do not represent the type of professional plaintiff this legislation seeks to restrict." H.R. Conf. Rep. 104-369, 1995 U.S.C.C.A.N. 730, 734.

[5] In the article that inspired the lead plaintiff provisions of the PSLRA, *see* S. Rep. 104-98, 1995 U.S.C.C.A.N. 679, 690 n.32, Professors Weiss and Beckerman predicted that "[t]he largest benefit of institutional supervision of class actions is likely to be settlement terms that are more favorable to the plaintiff class, on average, than those now negotiated by essentially unsupervised plaintiffs' attorneys." Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2121 (1995). Their prediction has been fulfilled, exactly as Congress intended.

time, a much larger percentage of suits filed since enactment of the PSLRA has been dismissed under the PSLRA's stringent pleading requirements.[6] Reflecting the PSLRA's deterrence of meritless cases, securities class action filings "plunged to a record low in 2006."[7]

SUMMARY OF ARGUMENT

Section 10(b)'s prohibition on the use of any "deceptive device or contrivance" should be construed in accordance with the plain language of the statute. This language does not require that a defendant make a misrepresentation or omission in order for liability to attach. The statutory language merely requires deception, which can be accomplished by conduct as well as by statements or omissions. Where a defendant engages in conduct with the purpose and effect of deceiving investors as part of a scheme to defraud, that constitutes the use of a deceptive device within the meaning of § 10(b).

Such construction of Section 10(b) is confirmed by the Securities and Exchange Commission's adoption of Rule 10b-5, 17 C.F.R. § 240.10b-5, pursuant to the Congressional authorization contained in Section 10(b). Rule 10b-5(a) prohibits any "scheme . . . to defraud," and Rule 10b-5(c) prohibits any "course of business which operates or would operate as a fraud or deceit upon any person." As this Court has recognized, these provisions

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[6] *See* Todd Foster et al., NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, 4 (Jan. 2007), *available at* http://www.nera.com/image/BRO_Recent_Trends_SEC1288_FINAL_0307.pdf.

[7] Cornerstone Research, *Securities Class Action Case Filings: 2006: A Year in Review*, 1 (2007), available at http://securities.cornerstone.com/pdfs/YIR2006.pdf.

clearly do not require the making of misleading statement or omission. *See Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-54 (1972). The S.E.C.'s longstanding understanding of the scope of Section 10(b) as reflected in Rule 10b-5 is entitled to deference.

Furthermore, on numerous occasions subsequent to the adoption of Rule 10b-5 by the S.E.C., Congress has reexamined and amended the private right of action under Rule 10b-5, but never expressed any concern that Rule 10b-5(a) and (c) went beyond the intended scope of Section 10(b). In such circumstances, Congressional approval of the way in which Rule 10b-5 implemented Section 10(b) should be presumed, and the Court should leave to Congress any change in the scope of this provision.

Finally, Congress's intent to maintain honest and efficient capital markets would be undermined if persons were allowed to escape liability when they engage in transactions whose purpose and effect is to deceive investors. There is no need for the Court to reduce the scope of Section 10(b) out of concern as to "vexatious" securities litigation. Subsequent to the enactment of the PSLRA, fewer securities class actions are being filed than in the past, and more actions are being terminated on motions to dismiss. Institutional investors are being appointed as lead plaintiffs, and previous concerns about lawyer-driven, meritless securities lawsuits have been largely addressed.

Fraud is corrosive to the economy. As this Court has recognized, there is a strong "federal interest in protecting the integrity and efficient operation" of the U.S. securities markets. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 126 S. Ct. 1503, 1509 (2006). Investor confidence in the integrity of the secu-

rities markets is key to the ability of businesses to raise capital, because without such confidence, investors " 'will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.' " *Basic Inc. v. Levinson*, 485 U.S. 224, 235 n.12 (1988) (quoting *In re Carnation Co.*, Exchange Act Release No. 22214, 33 SEC Docket 1025, 1030 (1985)).

To maintain investor confidence in the integrity of capital markets, to enable defrauded investors to recover as much of their losses as possible, and to avoid creating a loophole through which numerous actors could evade liability despite acting with scienter to deceive investors, the Court should follow the plain language of Section 10(b) and the Court's own precedents by reversing the Eighth Circuit's holding and finding that Section 10(b) liability need not be predicated on a statement or omission.

ARGUMENT

I. THE PLAIN LANGUAGE OF SECTION 10(b) INDICATES THAT PARTICIPATION IN A TRANSACTION THAT HAS NO LEGITIMATE BUSINESS PURPOSE AND THAT IS DESIGNED TO MISLEAD THE INVESTING PUBLIC CAN CONSTITUTE CONDUCT VIOLATIVE OF SECTION 10(b) NOTWITHSTANDING THAT THE ACTORS THEMSELVES MADE NO PUBLIC STATEMENTS OR OMISSIONS

This Court has stressed that in attempting to determine the scope of liability under Section 10(b), the Court must "turn first to the language of § 10(b), for '[t]he starting point in every case involving [the] construction of a statute is the language itself.' " *Ernst & Ernst v.*

Hochfelder, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)). Analysis of the language of Section 10(b) shows that it encompasses deceptive conduct regardless of whether the actor makes any statement or omission.

Section 10(b) makes no reference to statements or omissions, but rather contains a broad prohibition against the use of any "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe."[8] Deception can be achieved in numerous ways other than through false or misleading statements, and nothing in the statutory language requires that the defendant make a misrepresentation or omission in order for liability to attach under the section. This Court has noted that "device" means "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and that "contrivance" means "[a] thing contrived or used in contriving; a scheme, plan, or artifice." *Hochfelder*, 425 U.S. at 199 n.20 (quoting Webster's International Dictionary (2d ed. 1934)). As noted in *In re*

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[8] Section 10(b), 15 U.S.C. § 78j(b), provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Parmalat Securities Litigation, 376 F. Supp. 2d 472, 502 (S.D.N.Y. 2005), the same dictionary upon which the Court relied in *Hochfelder* defines "deceptive" as "[t]ending to deceive; having power to mislead."

Under these definitions, conduct that has the purpose and effect of creating a false impression can constitute a "deceptive device or contrivance" even if the actor does not make any statement. As the Ninth Circuit held in *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1052 (9th Cir. 2006): "We conclude that conduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b)." *See also Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, No. 06-20856, 2007 WL 816518, at *22 (5th Cir. Mar. 19, 2007) (Dennis, J., concurring in the judgment) ("a deceptive act includes a transaction whose principal purpose and effect is to create a false appearance of revenues, which can be accomplished by acts as well as by words") (quoting *In re Enron Corp. Securities, Derivative & ERISA Litigation*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *167-74 (S.D. Tex. June 5, 2006)).

Such interpretation of the statutory language of Section 10(b) is particularly apt in light of this Court's consistent teaching that "securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.' " *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983) (quoting *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)). In particular, the Court has stated that Congress intended Section 10(b) and Rule 10b-5 to enjoy a broad interpretation insofar as the question of what constitutes deception or

a fraudulent scheme within their scope is concerned. In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), which involved a complicated series of transactions whereby the defendant purchased a corporation's stock with the corporation's own assets, the Court held that the plaintiff stated a claim under Section 10(b) and Rule 10b-5 because there "was an 'act' or 'practice' within the meaning of Rule 10b-5 which operated as 'a fraud or deceit' " on the seller of securities. *Id.* at 9. The Court further stated:

> We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.

Id. at 11 n.7 (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). If the scope of Section 10(b) were limited to situations where the defendant made a misrepresentation, it is doubtful the Court would have used the above-quoted language or reached the result it did.

Because a person employing a deceptive device or contrivance commits a primary violation of Section 10(b), liability for such conduct is not barred by this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 191 (1994), that there is no private civil claim for aiding and abetting a Section 10(b) violation. In *Central Bank*, the plaintiffs conceded that the defendant "did not commit a manipulative or deceptive act within the meaning of § 10(b)" and therefore the question of what constitutes a primary violation of the statute was not at issue. *Id.; see Credit Suisse First Boston*, 2007 WL 816518, at *21 (Dennis, J., con-

curring in the judgment).[9] Additionally, in *Central Bank*, the Court expressly recognized that so-called "secondary actors" are subject to liability under Section 10(b) when they commit primary violations of that statute, including violations involving acts other than the making of false statements:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device *or* makes a material misstatement (or omission) on which a purchaser . . . relies may be liable as a primary violator under 10b-5 . . . . In any complex securities fraud, moreover, there are likely to be multiple violators. . . .

Central Bank, 511 U.S. at 191 (emphasis added).

Subsequent to *Central Bank*, this Court has continued to recognize that liability under Section 10(b) need not be premised on false or misleading statements but rather can be based upon a defendant's commission of deceptive acts or participation in a fraudulent scheme. In *S.E.C. v. Zandford*, 535 U.S. 813 (2002), this Court reversed the dismissal of a Rule 10b-5 claim against a broker who had converted proceeds from sales of his customers' securities to his own use, even though the broker was "able to carry out his fraudulent scheme

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[9] *See also In re Parmalat Sec. Litig.*, 376 F. Supp. 2d at 493 (*Central Bank* "did not change the scope of Rule 10b-5 or what constitutes a primary violation of it"); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 171 (D. Mass. 2003) (in *Central Bank* "[t]he Supreme Court did not reach the issue of the extent to which participants in a securities fraud scheme are primary violators of § 10(b).").

without making an affirmative misrepresentation," *id.* at 822, because allegations that he had "engaged in a fraudulent scheme" and a "course of business that operated as a fraud or deceit" were sufficient to state a claim. *Id.* at 820-21.[10]

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[10] Numerous cases in the lower courts similarly have upheld claims under Section 10(b) based on the defendants' participation in fraudulent schemes. While the exact formulations have differed, the central theme is that Section 10(b) reaches deceptive conduct and not merely misstatements or omissions. *See Benzon v. Morgan Stanley Distrib.*, 420 F.3d 598, 610 (6th Cir. 2005) ("Rules 10b-5(a) and (c) encompass conduct beyond disclosure violations . . . . We therefore conclude that the district court's determination that Defendants complied with their disclosure obligations does not dispose of Plaintiffs' claims under Rule 10b-5(a) and (c)"); *S.E.C. v. U.S. Envtl., Inc.*, 155 F.3d 107, 111 (2d Cir. 1998) ("a primary violator is one who 'participated in the fraudulent scheme' or other activity proscribed by the securities laws"); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d at 506 (Section 10(b) claim upheld where the banks' conduct "created the appearance of revenue or assets where there was none and thus distorted the prices of Parmalat's securities"); *WM High Yield Fund v. O'Hanlon*, No. 04-3423, 2005 WL 1017811, at *8 (E.D. Pa. Apr. 29, 2005) ("given the massive fraudulent scheme set forth by Plaintiffs in their Complaint . . . it appears that they have set forth sufficient facts to survive a Motion to Dismiss as to all Defendants on the basis of Rule 10b-5(a)/(c) liability"); *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330, 338 (D. Mass. 2005) ("Plaintiffs have alleged a primary violation of Rule 10b-5 by defendant through its participation in a manipulative or deceptive scheme intended to mislead investors."); *In re AOL Time Warner Sec. & ERISA Litig.*, 381 F. Supp. 2d 192, 217 (S.D.N.Y. 2004) (claim stated under Section 10(b) where it was alleged that defendants "engaged in a systematic scheme . . . to inflate AOL's reported advertising revenue . . . based on various sham transactions . . . ."); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335 (S.D.N.Y. 2004) ("a cause of action exists under subsections (a) and (c) [of Rule 10b-5] for behavior that constitutes participation in a fraudulent scheme, even absent a fraudulent statement by the defendant"); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d at 173 ("any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative

The court below relied on *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), for the proposition that deceptive conduct must involve "either a misstatement or a failure to disclose by one who has a duty to disclose." *In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987, 990 (8th Cir. 2006). *Santa Fe*, however, involved the question of whether a garden variety breach of fiduciary duty constituted a violation of Rule 10b-5 and did not address the contours of scheme liability under Section 10(b). It is, therefore, not dispositive of the issue at bar. Nevertheless, the language that the Court employed in *Santa Fe* refutes the proposition for which the Eighth Circuit cited it. In *Santa Fe*, the Court explained that the Court's prior cases all "included some element of deception," and did not "support the proposition . . . that a breach of fiduciary duty by majority stockholders, without any *deception, misrepresentation, or nondisclosure*, violates the statute and the Rule." 430 U.S. at 475-76 (emphasis added). As Judge Dennis observed in his concurring opinion in *Credit Suisse First Boston,* by referring to deception separately from misrepresentations and nondisclosures, the Court's language in *Santa Fe* "affirmatively indicates that 'deceptive' conduct need not always be in the form of a misrepresentation or an omission." 2007 WL 816518, at *21.

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or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market" is liable under Section 10(b)); *In re Williams Sec. Litig.*, 339 F. Supp. 2d 1206, 1237 (N.D. Okla. 2003) (complaint sufficiently alleged primary Rule 10b-5 liability based on participation in scheme to defraud); *Rich v. Maidstone Fin., Inc.*, No. 98-2569, 2002 WL 31867724, at *8 n.6 (S.D.N.Y. Dec. 20, 2002) ("the Second Circuit continues to permit plaintiffs to allege 'participation in' a securities fraud scheme as one manner in which a plaintiff may state a claim under § 10(b) and Rule 10b-5.").

Moreover, in *Santa Fe*, the Court also stated that "Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices" when it enacted Section 10(b). 430 U.S. at 477. It would be inconsistent with this Congressional intent to remove from the scope of Section 10(b) claims against persons who engage in transactions that lack legitimate business purpose and are designed to deceive the investing public. Indeed, as Professor John Coffee recently observed, if the decision below is affirmed, effectively "the gatekeepers should be able to go back to sleep." John C. Coffee, Jr., *Future of Class Actions Depends on Pending Cases*, N.Y. Law Journal, Mar. 27, 2007, at 5. That cannot be what Congress intended, given the Congressional intent underlying Section 10(b) "to insure honest securities markets and thereby promote investor confidence." *Zandford*, 535 U.S. at 819 (quoting *United States v. O'Hagan*, 521 U.S. 642, 658 (1997)).

II. THE S.E.C.'S LONGSTANDING INTERPRETATION OF SECTION 10(b) AS REFLECTED IN RULE 10b-5 IS ENTITLED TO DEFERENCE

That Section 10(b) encompasses deceptive conduct beyond mere misrepresentations or omissions is reinforced by the language of Rule 10b-5(a) and (c). In Section 10(b), Congress specifically made it unlawful for any person "to employ any deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Pursuant to this authorization, in 1942 the Securities and Exchange Commission promulgated Rule 10b-5, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instru-

> mentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

Only subpart (b) requires a misstatement or omission by the defendant; subparts (a) and (c), which proscribe any scheme to defraud or any conduct which operates as a fraud or deceit, on their face clearly do not. *See Affiliated Ute*, 406 U.S. at 152-53 ("To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted."). *See also Benzon*, 420 F.3d at 610 ("A plain-language reading" of Rule 10b-5 supports the view that "a defendant not liable under Rule 10b-5(b) for failure to disclose . . . may still be held liable under Rule 10b-5(a) and Rule 10b-5(c) as a participant in [an] allegedly fraudulent scheme") (internal quotation marks omitted).

Of course, the scope of Rule 10b-5 "cannot exceed the power granted the Commission by Congress under § 10(b)." *Hochfelder*, 425 U.S. at 214. However, as discussed above, Section 10(b) leaves it to the S.E.C. to promulgate rules defining the parameters of Section 10(b)'s prohibitions, "as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b). In such circumstances, the S.E.C.'s construction of § 10(b) as reflected in Rule 10b-5 is entitled to deference. As stated in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984) (internal citations omitted):

> [I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.
>
> "The power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress." If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.

See also Rapanos v. United States, 126 S. Ct. 2208, 2235-36 (2006) (Roberts, C.J., concurring) ("Agencies delegated rulemaking authority under a statute . . . are

afforded generous leeway by the courts in interpreting the statute they are entrusted to administer.").

In the exercise of the rulemaking authority that Congress delegated to it in Section 10(b), the S.E.C. determined that it was appropriate to prohibit fraudulent schemes and practices that would operate as a fraud. Such interpretation and rulemaking by the S.E.C. are reasonable and therefore entitled to deference.[11]

III. BECAUSE CONGRESS CHOSE NOT TO RESTRICT THE BROAD SCOPE OF RULE 10b-5(a) AND (c) WHEN IT REEXAMINED THE PRIVATE CIVIL RIGHT OF ACTION UNDER SECTION 10(b), THIS COURT SHOULD NOT DO SO EITHER

Rule 10b-5 was adopted in 1942, and since that time Congress has on several occasions reexamined and amended the provisions of the Securities Exchange Act bearing on the implied private right of action under Rule 10b-5, most recently in 2002 when it passed the Sarbanes-Oxley Act and previously in 1995 and 1998 when it passed the PSLRA and the Securities Litigation Uniform Standards Act ("SLUSA"), respectively. These were not mere amendments to the Securities Exchange Act in general, but rather focused directly on the private right of action under Rule 10b-5, addressing such mat-

---

[11] There are, of course, limits on the deference due the S.E.C. with respect to Rule 10b-5. In *Hochfelder*, for example, this Court held that the S.E.C.'s view that negligent conduct violated Rule 10b-5 was not reasonable given that Section 10(b) specifically referred to manipulation and deception—"the commonly understood terminology of intentional wrongdoing." 425 U.S. at 214. Here, by contrast, the S.E.C.'s view as expressed in Rule 10b-5(a) and (c) that Section 10(b) can be violated by deceptive conduct or participation in a fraudulent scheme does not run afoul of any words in Section 10(b).

ters as the pleading standards, loss causation, damages, statutes of limitation, jurisdiction, proportionate liability, and contribution rights. *See* 15 U.S.C. § 78u-4; 15 U.S.C. § 78bb(f); 28 U.S.C. § 1658(b).

These reexaminations and amendments left intact the provisions of Rule 10b-5(a) and (c). Under such circumstances, Congressional approval of the S.E.C.'s implementation of Section 10(b) as manifested in Rule 10b-5, as well as this Court's interpretation of Rule 10b-5 as expressed in *Affiliated Ute* and *Superintendent of Insurance*, should be presumed, and it should be left to Congress to make any change in the scope of Section 10(b) as implemented by Rule 10b-5. As this Court stated in *Barnhart v. Walton*, 535 U.S. 212, 220 (2002), Congressional reexamination of a statutory provision with knowledge of the relevant agency's interpretation thereof provides evidence "that Congress intended the Agency's interpretation, or at least understood the interpretation as statutorily permissible." *See also Square D Co. v. Niagara Frontier Tariff Bureau, Inc.*, 476 U.S. 409, 420 (1986) ("Congress must be presumed to have been fully cognizant of [judicial] interpretation of the statutory scheme, which had been a significant part of our settled law for over half a century, and that Congress did not see fit to change it when Congress carefully reexamined this area of law"); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-82 (1982) (Congressional amendment and reenactment of the Commodities Exchange Act without eliminating judicially created private right of action reflects Congressional approval of such right).

IV. REVERSAL OF THE DECISION BELOW WOULD FURTHER THE STRONG CONGRESSIONAL POLICY OF STRENGTHENING THE INTEGRITY OF SECURITIES MARKETS AND PROTECTING INVESTORS

As this Court long has recognized, private securities litigation is a valuable part of the overall enforcement regime that compensates defrauded investors, deters fraud, promotes investor confidence and facilitates the fair and efficient functioning of our capital markets. "The magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 126 S. Ct. 1503, 1509 (2006). "[P]rivate enforcement" of Rule 10b-5 provides "a necessary supplement to Commission action." *Blue Chip Stamps*, 421 U.S. at 730.

There is no need for the Court to strain to excuse from liability persons engaged in fraudulent conduct out of any concern over what the Court previously has characterized as "vexatious" securities litigation. *See, e.g., Blue Chip Stamps*, 421 U.S. at 743. As Professor John Coffee noted recently, "under the PSLRA this problem may have subsided." John C. Coffee, Jr., *supra*, at 5. Indeed, the facts indicate that the PSLRA has already achieved Congress's intent to remedy perceived abuses in private securities litigation. Since 1995, the dynamics of securities class actions, especially cases involving large investor losses, have changed radically. Institutional investors have come to the fore in most such cases, seeking appointment as lead plaintiffs, pressing counsel to prosecute class members' claims vigorously, and negotiating lower attorney fees, as a percentage of recoveries, than was typical before the PSLRA. Poten-

tially frivolous cases no longer pose the problems that previously worried courts, while meritorious cases have gained prominence in response to recent outbreaks of corporate wrongdoing.

Based upon the most recent evidence, under the PSLRA, recoveries have increased, the number of lawsuits filed has substantially declined, and the dismissal rate has jumped. The most recent study by NERA Economic Consulting, whose work was cited by Congress when debating the PSLRA, found that in 2006, federal securities class action filings dropped 36% from 2005 and 44% from the overall post-PSLRA average. *See* Todd Foster et al., *supra* note 6 at 2. A similar study by Cornerstone Research found a 49% decline from 2005 and a 53% decline from the historic average. *See* Cornerstone Research, *supra* note 7, at 1. Moreover, NERA reports that "the probability of a company facing a suit that survives a motion to dismiss has fallen by more than 30%," and that the probability of a shareholder class action in the first place has dropped nearly 10%. Todd Foster et al., *supra* note 6, at 3. Dismissal rates have doubled since the passage of the PSLRA. *See id.* at 4. On the other hand, with regard to settlement value, NERA reports:

> This year will stand out as one of record settlements. There were more settlements over $100 million—the so-called mega-settlements—in 2006 than in 2005, itself a record-breaking year.

Id. at 1.

Thus, fewer cases are being filed, and those that proceed to discovery are much stronger, resulting in larger recoveries for plaintiffs. Private securities litigation has proven itself a valuable tool in the protection of

investors and the deterrence of securities fraud, and no policy reason exists to allow persons who participate in transactions designed to mislead investors to escape liability under Section 10(b). Indeed, such a result would do great harm to investor interests, as it would leave them with no viable means to recover damages sustained as a result of even intentionally deceptive conduct, so long as the wrongdoer avoids making a false statement or assuming a duty of disclosure. Given the complexity of corporate frauds, this will create a significant and unwarranted loophole in Rule 10b-5.

Elimination of any claim under Section 10(b) based on deceptive schemes to defraud would likely result in some plaintiffs bringing comparable claims under state law in state court. While under SLUSA such claims could not be brought as class actions, preventing small investors, as a practical matter, from obtaining relief, large investors with large individual claims might still find such a course of action feasible.[12] Such a migration of claims to the state courts, with varying substantive and procedural law, was precisely what Congress sought to prevent when it adopted SLUSA.

Preventing fraud in the purchase or sale of securities furthers the interests of both investors and honest businesses, because investor confidence in the integrity of the securities markets is crucial to helping businesses raise the capital that they require. *See Basic Inc. v. Levinson*, 485 U.S. 224, 235 n.12 (1988). By seriously impairing the ability of investors to recover for fraud,

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[12] In the wake of the Fifth Circuit's decision restricting the scope of Rule 10b-5(a) and (c) in *Credit Suisse First Boston*, 2007 WL 816518, numerous state court suits by large investors are expected. *See* Carrie Johnson, *Investors Defeated in Enron Decision; Investment Banks Ruled Not Liable*, Wash. Post, Mar. 20, 2007, at D01.

the decision below is damaging not only to investors but to also to legitimate businesses that need to resort to the capital markets.

CONCLUSION

It is respectfully submitted that the judgment of the Court of Appeals should be reversed.

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF MERRILL LYNCH & CO., INC. AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICUS CURIAE*[1]

Merrill Lynch & Co., Inc. ("Merrill Lynch") is a diversified financial services company with over 60,000 employees worldwide. Merrill Lynch has previously filed amicus briefs in other cases before this Court that involved the federal securities laws or that affected the securities industry, including *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336 (2005); *Rodriguez de Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989); and *Shearson/American Express, Inc.* v. *McMahon*, 482 U.S. 220 (1987). Merrill Lynch is filing this amicus brief principally to respond to the amicus brief of the Regents of the University of California ("the Regents"), which have separately filed a petition for certiorari that apparently is being held pending the disposition of this case. *See Regents of the Univ. of Cal.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 06-1341 ("*Enron*"), *petition for cert. filed* (Apr. 5, 2007). Merrill Lynch is one of the respondents in the *Enron* case.

This brief does not propose to address every issue or argument in this case. Respondents and other amici will do that. This brief focuses on two points. First, it responds to the Regents' improper suggestion that the Court's decision in this case should be guided by the potential consequences of that decision on the parties in *Enron*. Second, *Enron* illustrates a number of critical flaws in expanding the implied cause of action under §10(b) of the Securities Exchange Act

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[1] Pursuant to this Court's Rule 37.6, *amicus curiae* states that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amicus curiae* made a monetary contribution to the preparation or submission of this brief.

Pursuant to Rule 37.3, *amicus curiae* states that petitioner and respondents have consented to the filing of this brief. Petitioner has filed with the Clerk of the Court a letter granting blanket consent to the filing of amicus briefs, and a letter reflecting the consent of respondents to the filing of this brief has been filed with the Clerk.

of 1934 ("Exchange Act"), 15 U.S.C. §78j(b), to include "scheme" liability.[2] These flaws include that "scheme" liability has no workable theory for what constitutes deception by commercial counterparties; does not satisfy other requirements for primary liability, such as reliance, loss causation, and the requirement in §10(b) that the deception be "in connection with" the purchase or sale of a security; is incompatible with the express causes of action in the securities statutes; and is unnecessary to deter wrongdoing by commercial counterparties. Regarding this last point, Merrill Lynch notes that it has paid a total of $109 million in cash to the U.S. Securities and Exchange Commission ("SEC") and to Enron's bankruptcy estate, nearly eight times more than it earned from its allegedly improper transactions with Enron.

STATEMENT OF THE CASE

Rather than present a traditional statement about the facts in this case, which will be thoroughly set forth by the respondents, Merrill Lynch provides a short summary of facts concerning the *Enron* case, in order to respond to misstatements and mischaracterizations in the Regents' brief. This is a prelude to our later demonstration that how the decision in this case may impact *Enron* is *not* relevant to the legal issues presented in this case. *See infra*, at 12-13. Indeed, it was improper for the Regents to suggest that the Court should consider the *Enron* case in deciding the legal issues before it in this case given that the Court does not decide cases that are not before it, nor does the Court interpret

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[2] As used throughout this brief, the phrase "'scheme' liability" refers to a theory of implied private civil liability under §10(b) invented by resourceful plaintiffs' class action counsel to ensnare defendants, such as commercial counterparties, that have made no misrepresentations to the market and had no duty to make disclosures to the issuer's investors. *See, e.g.*, Br. of Ohio, et al., as Amicus Curiae in Support of Petitioner at iii (defining Question Presented as: "Whether shareholders can recover damages from actors . . . even when the actor has made no false statement or omission and otherwise owes no fiduciary duty to the shareholders.").

statutes, such as the Exchange Act, or the elements of an implied cause of action, such as under §10(b), in an effort to favor parties in other cases.

The Regents' brief contains numerous factual misstatements or mischaracterizations about the *Enron* case that are contradicted by findings of federal judges and the Enron bankruptcy examiner, who reviewed the relevant factual records. The Regents' brief also omits critical facts about the Enron transactions that involved Merrill Lynch, ignores the significant payments that Merrill Lynch already has made in connection with those transactions, and grossly exaggerates the impact of Merrill Lynch's alleged conduct on investors and on the Regents' beneficiaries. Without addressing all of the Regents' factual misstatements and omissions, Merrill Lynch notes the following:

1. The Regents' rhetorical references to "the worst securities fraud in recent history," Regents' Br. at 5, should not obscure the fact that the Regents' claims against **Merrill Lynch** principally concern only three transactions that had a relatively insignificant impact on Enron's financial statements (*see infra*, at 21 n.6). Judicial decision makers in the *Enron* litigation have characterized these transactions much differently than have the Regents. The three transactions are: (1) Merrill Lynch's purchase of an interest in three barge-mounted power plants in Nigeria (the "barge" transaction); (2) Enron's purchase and sale of energy options from Merrill Lynch (the "energy option" transactions); and (3) the LJM2 limited partnership ("LJM2"), in which Merrill Lynch was one of 47 passive investors.

a. In 1999, Enron sold Merrill Lynch an interest in barges from which power was to be generated and sold to the Nigerian government. Enron, which initiated the transaction, booked approximately $12 million in income as a result of that sale to Merrill Lynch. Six months later, Merrill Lynch sold its interest in the Nigerian barges to LJM2. The Government claimed that Enron had booked profits on the

original sale to Merrill Lynch in order to inflate its reported revenues for 1999, but should not have done so because Enron had guaranteed that it would get Merrill Lynch out of the barge transaction within six months. The Government criminally charged certain former Merrill Lynch employees, who had participated in the barge transaction with Enron's Chief Financial Officer, Andrew Fastow, with aiding and abetting **Enron's** fraud.

Concurring in the Fifth Circuit's reversal of the criminal conviction of the former Merrill Lynch employees, Judge DeMoss disagreed with the Government's characterization of the barge transaction as a "sham" and concluded that any "wrong arising from [the transaction] . . . would be in Enron's employees' reporting of the transaction . . . *not in the manner in which Merrill's employees negotiated the deal.*" *United States* v. *Brown*, 459 F.3d 509, 536 (5th Cir. 2006) (DeMoss, J., concurring in part and dissenting in part) (emphasis added). In support of this conclusion, Judge DeMoss noted that:

> (1) Fastow himself averred to the Government that he, in fact, made only assurances of best efforts to Merrill, not promises or guarantees to take Merrill out of the deal; and (2) in conformance with the written agreement, Merrill actually paid $7 million to Enron, consistent with its purchase of an interest in the barge partnership investment, and therefore had absolutely no legally enforceable claim to be taken out of the deal.

Id. This analysis of the barge transaction by Judge DeMoss is completely at odds with the Regents' sweeping and unspecified allegations about "fake" transactions and "secret oral guarantees" by unspecified Enron "Banks." *See* Regents' Br. at 10-11.

b. At Enron's suggestion, Merrill Lynch entered into a series of call options that involved the purchase and sale of electricity. Large energy trading companies often engage in such transactions. *See* Dep. Tr. of Gary W. Dorris at 132:17 to 133:18 and 150:10-21. Enron booked a profit as a result of its energy option transactions with Merrill Lynch, with the approval of its auditors, Arthur Andersen. The only relevant dispute about the energy option transactions is whether Merrill Lynch faced risk with regard to those transactions.

The Regents' own expert conceded that "risk" was "borne by Merrill Lynch and Enron as a result of these energy trades." *See* Washer Decl. Ex. 2 (in support of SJ motion), Dep. Tr. of Joel Finard at 199:5-9. Merrill Lynch set aside reserves in connection with these transactions, a practice that indicates that Merrill Lynch believed at the time that the trades presented risk. *See* Washer Decl. Ex. 22, Dec. 1999 Reserves Explanations, MLNBY 0924434. In addition, another Regents' expert conceded that Merrill Lynch entered into hedges in connection with the energy transactions. Hakki Decl. Ex. D, Dep. Tr. of Saul Solomon at 760:4-7. Hedges typically were used because a transaction presented risk. *Id.* at 760:8-19.

c. LJM2 was an investment fund with 47 limited partner investors, including Merrill Lynch. Merrill Lynch also participated in a syndicate loan to LJM2 and acted as private placement agent for LJM2. Enron's bankruptcy examiner, Neal Batson, concluded that Merrill Lynch's involvement in LJM2 did not provide a basis for a claim against it of aiding and abetting Enron's officers in breaching their fiduciary duties, noting that he had

> discovered no evidence to date that would indicate Merrill Lynch had any role in the day-to-day operations of LJM2 or in the selection or approval of the transactions entered into by LJM2. Rather, Merrill Lynch's role appears to have been limited

> to that of a private placement agent and a passive limited partner/investor.

Washer Decl. Ex. 16, Appendix I to Third Interim Report of Neal Batson, Court-Appointed Examiner, *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y.) at 46 (June 30, 2003) ("Batson Report"). Similarly, there have been no enforcement or criminal proceedings concerning Merrill Lynch's role in LJM2.

2. To the extent that the Regents have asserted that Merrill Lynch and other Banks "designed," "devised," "structured" or "contrived" various Enron transactions (*see* Regents' Br. at 2, 4, 6, 10-11, 29), those allegations (at least insofar as they relate to Merrill Lynch) are contradicted by the findings of Enron's bankruptcy examiner.

The examiner specifically found that "the evidence indicates that **Enron** designed the Nigerian Barge transaction" and "that Merrill Lynch was not involved in structuring the Nigerian Barge transaction." Batson Report at 30-31 (emphasis added).[3] The examiner also found that "Enron designed the electricity trade transactions" and that "Merrill Lynch's only involvement in structuring the deal appears to have been its negotiation of the amount of its fee." Batson Report at 42. Finally, as previously noted, the examiner specifically found "no evidence to date that would indicate Merrill Lynch had any role in the day-to-day operations of LJM2 or in the selection or approval of the transactions entered into by LJM2." Batson Report at 46.

The Regents rely principally upon incomplete and misleading snippets of testimony from Mr. Fastow, who became the Government's star witness after pleading guilty to

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[3] Like the bankruptcy examiner, the district judge at the Enron barge criminal trial found that executives of Enron, rather than former employees of Merrill Lynch, were the "organizers, leaders, manager[s], and supervisors" of the barge transaction. Hakki Decl. Ex. A, Bayly Sentencing Tr. at 24:14-21.

felony charges. *See* Regents' Br. at 11-12. But even Mr. Fastow's testimony concerning transactions that specifically involved **Merrill Lynch** shows that Merrill Lynch did not design or devise those transactions:

a. With respect to the barge transaction, Mr. Fastow agreed that "it was someone at Enron, rather than Merrill Lynch, who came up with the idea of having Merrill Lynch purchase that barge interest." Dep. Tr. of Andrew Fastow at 1311. Mr. Fastow also could not dispute the fact that "Merrill Lynch played no role in preparing the actual accounting entries regarding the barge transaction that flowed into Enron's 1999 financial statements." Fastow Dep. Tr. at 1314.

b. Mr. Fastow's testimony is that *he* "created" the LJM2 partnership entity "with my limited partners and accountants and attorneys." Fastow Dep. Tr. at 1071. Mr. Fastow also testified that LJM2's structure was legal and it was only his subsequent misuse of the partnership in certain transactions that was improper. Fastow Dep. Tr. at 1076 ("my personal opinion is that the LJM entities were legal, but that some of the things I did with LJM were not legal").

Significantly, Mr. Fastow agreed that Merrill Lynch had no role in selecting LJM2's investments or in structuring the individual transactions in which the LJM2 partnership invested or participated. Fastow Dep. Tr. at 1357-58 (Merrill Lynch did not "bring[] any of these investment opportunities to LJM2," did not "recommend[] that LJM2 participate in these transactions," nor did it "actually structure any of the transactions"). It was Mr. Fastow's staff at LJM2, "primarily working with people at Enron," who "identified these opportunities and brought them to the LJM2 limited partners as prospective investments." Fastow Dep. Tr. at 1370.

3. The Regents assert that "Banks reaped huge profits" by participating in the alleged scheme that they will retain unless private civil class action plaintiffs can sue them under §10(b). *See* Regents' Br. at 5. This assertion certainly does

not apply to Merrill Lynch. Merrill Lynch earned a total of approximately $14 million from the allegedly improper Enron transactions (approximately $775,000 from the barge transaction, approximately $8.5 million from the energy option transactions, and approximately $5 million from LJM2). *See Brown*, 459 F.3d at 516 ("Merrill made $775,000 on its investment in the barges"); "SEC Charges Merrill Lynch, Four Merrill Lynch Executives with Aiding and Abetting Enron Accounting Fraud" (Mar. 17, 2003), *available at* http://www.sec.gov/news/press/2003-32.htm ("SEC Press Release") ("Merrill Lynch agreed to reduce its fee to $8.5 million to terminate the [energy option] transaction"); MLNBY 0050806 (Merrill Lynch's fees on the LJM2 transaction were "approximately $5 million").

In other proceedings, Merrill Lynch already has paid $109 million – nearly eight times more than the $14 million it earned – to resolve claims related to these transactions with Enron. In 2003, the SEC brought a complaint against Merrill Lynch and four former employees for *aiding and abetting* Enron's violations of the federal securities laws in connection with the barge and energy option transactions. *See* Complaint, *SEC* v. *Merrill Lynch & Co., Inc., et al.*, No. H-03-0946 (S.D. Tex. Mar. 2003), *available at* http://www.sec.gov/litigation/complaints/comp18038.htm (asserting claims against the Merrill Lynch defendants for aiding and abetting Enron's violations of §§10(b), 13(a), and 13(b) of the Exchange Act and related rules). Merrill Lynch, without admitting or denying the SEC's allegations, paid the SEC $80 million in disgorgement, penalties, and interest to settle that case. *See* SEC Press Release. These funds were to be distributed to investors in accordance with the Fair Fund provisions of the Sarbanes-Oxley Act of 2002. *Id.*

In agreeing to resolve the matter on these terms, the SEC expressly noted that it

> took into account certain affirmative conduct by Merrill Lynch. Merrill Lynch terminated [two

> employees] after they refused to testify before the staff and instead asserted their Fifth Amendment rights. In addition, Merrill Lynch brought the energy trade transaction to the staff's attention at a time when it believed the staff was unaware of its existence.

Id.

In addition, in the Enron bankruptcy proceeding, Merrill Lynch paid the Enron estate approximately $29.5 million to settle claims brought against it for its role in the barge, energy option, and LJM2 transactions.

Thus, when the Regents' inflamed rhetoric is stripped away and contrasted with the neutral assessments of the Enron bankruptcy examiner and federal judges, the facts that emerge are that: (1) Merrill Lynch played a minor role in a small number of the many transactions that Enron initiated, and (2) Merrill Lynch has been held fully accountable for that role through administrative and bankruptcy proceedings that have required Merrill Lynch to pay many times more than the amounts that Merrill Lynch earned on the barge, energy option and LJM2 transactions with Enron.

Despite these facts, the Regents are suing Merrill Lynch for approximately $40 *billion*, an amount that is nearly *3000* times as large as those earnings. This can hardly be characterized as "disgorgement" of Merrill Lynch's profits, but is merely an effort to extort huge sums of money from a deep-pocket defendant because the true malefactors went bankrupt, lost their assets to Government seizures, or had inadequate insurance. *See* Regents' Br. at 5 (discussing Enron's bankruptcy, the collapse of its accountants, limited insurance, and Government seizure of key insiders' assets).

4. The Regents make an emotional appeal that the Court should decide this case in a way that would advantage the "thousands of investors" who lost "billions of dollars" in the collapse of Enron. *See* Regents' Br. at 5. But the suggestion

that Enron investors suffered harm *caused by Merrill Lynch's conduct* has been rejected in other contexts. For example, at the criminal sentencing of the former Merrill Lynch employees who were convicted of aiding Enron's fraud arising from the barge transaction, the court, using a loss causation standard based on *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336 (2005), concluded that "[n]o loss or intended loss can be proved to [be] reasonably estimate[d] in this case." Bayly Sentencing Tr. at 16-17 (noting "the Government's inability to prove economic loss or loss causation in a conventional manner"). The court found that only "$0.01 per share putative earnings" were derived by Enron from the barge transaction, which was dwarfed by Enron's 1999 earnings per share of approximately $1.10 and its $44 share price at the time of the transaction. *Id.* at 18.

5. Finally, the Regents' brief grossly exaggerates the extent to which their pension and endowment funds have suffered losses because of the collapse of Enron. *See* Regents' Br. at 1, 2, 6 n.8. Given that the Regents oversee a highly diversified institutional portfolio, the aggregate impact of Enron losses on their portfolio's value and performance was, by the Regents' own admission, relatively small. Charles McFadden, "UC joins federal class-action suit against Enron executives," at 2 (Jan. 7, 2002), *available at* http://www.ucsc.edu/currents/01-02/01-07/enron.html (quoting the Regents' treasurer as stating that, even with the Enron losses, the "University of California Retirement Plan[] equity portfolio recorded a return of 7.70 percent [for 2001], which was within 0.08 percent of its performance benchmark."). In particular, the Regents stated that their Enron losses "in no way affect[ed] the ability of the retirement plan . . . to meet its obligations to [its] beneficiaries." *Id.*

SUMMARY OF ARGUMENT

1. It is improper for the Regents to ask this Court to decide this case purposefully to dictate a victory for the Regents in *Enron*. This Court only decides the case before it and this Court has not granted certiorari in *Enron*. More generally, this Court decides legal issues of statutory interpretation and determines the elements of private civil liability based on neutral legal principles, not to assure favorable outcomes for certain parties.

2. *Enron* illustrates several legal flaws that require rejection of "scheme" liability:

(a) "Scheme" liability lacks a workable theory of what constitutes deception by commercial counterparties. The fact that the district court in *Enron* repeatedly flip-flopped on whether particular defendants and transactions fell within the reach of "scheme" liability demonstrates this point.

(b) The Court's decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), requires that the particular defendant's device or contrivance satisfy all elements of primary liability under §10(b). But in *Enron*, as in this case, plaintiffs have improperly sought to use "scheme" liability to avoid dealing with key elements of a claim under §10(b), including reliance and loss causation.

(c) No matter what label is chosen by plaintiffs' class action counsel, the core of "scheme" liability is assisting the issuer's misstatement. That is aiding and abetting.

(d) Contrary to *Central Bank*, "scheme" liability under §10(b) would improperly expand the defendant class for Rule 10b-5 actions "beyond the bounds delineated for comparable express causes of action," 511 U.S. at 180, in particular §18(a) of the Exchange Act. The Regents did not sue Merrill Lynch under §18(a) because it could not satisfy the elements of that express cause of action.

(e) Because other potent remedies are available, "scheme" liability is not needed to deter potential wrongdoing by commercial counterparties. This is illustrated by the fact that Merrill Lynch has paid $109 million to the SEC and Enron's bankruptcy trustee. In 1995, Congress decided to create an express action that allowed the SEC, but *not* private plaintiffs, to sue secondary actors. This dichotomy was "a deliberate congressional choice with which the courts should not interfere." *Central Bank*, 511 U.S. at 184.

ARGUMENT

I. THE COURT SHOULD IGNORE THE REGENTS' IMPROPER SUGGESTION THAT THIS COURT DECIDE THIS CASE IN A WAY THAT ASSURES THE REGENTS OF A VICTORY IN *ENRON*.

The Regents suggest that, in deciding whether there is an implied cause of action for "scheme" liability in this case, the Court should consider how that decision would impact the ability of the Regents to prevail in *Enron*. Regents' Br. at 5, 21. This suggestion is improper and is contrary to this Court's well-established practice.

The Court has not granted certiorari in the *Enron* case. Thus, in this case, the Court does not have before it either the voluminous *Enron* record (the appellate record alone exceeds 39,000 pages) or any arguments particular to *Enron*. After the Court announces the legal rule in this case, it can, if it chooses, address the petition being held in *Enron*.

As the Regents should be aware, this Court does not decide cases that are not before it and there is no reason to expect the Court to depart from that practice here. *See Citizens Against Rent Control/Coal. for Fair Hous.* v. *City of Berkeley, CA*, 454 U.S. 290, 299 n.6 (1981) (rejecting position that "argues a case not before the Court"). Moreover, this Court repeatedly adopts legal rules and renders legal decisions without regard to the media attention a particular case

receives. For example, despite the publicity associated with Enron's collapse, when this Court adjudicated a prior Enron-related case, it unanimously reversed a criminal conviction. *See Arthur Andersen LLP* v. *United States*, 544 U.S. 696 (2005).

Contrary to the Regents' preference, in cases such as this, which require interpretation of "enormously complex and detailed statute[s] that resolve[] innumerable disputes between powerful competing interests," the Court does not merely resolve all questions "in favor of potential plaintiffs." *Mertens* v. *Hewitt Assocs.*, 508 U.S. 248, 261-62 (1993). This Court has repeatedly adhered to neutral legal principles dictated by the rule of law, even when substantial financial crises have given rise to improper requests that the federal courts consciously establish pro-plaintiff rules. *See, e.g.*, *O'Melveny & Myers* v. *FDIC*, 512 U.S. 79, 88 (1994) ("Our cases have previously rejected 'more money' arguments remarkably similar to the one made here.").

II. *ENRON* ILLUSTRATES FUNDAMENTAL FLAWS IN "SCHEME" LIABILITY THEORIES.

Enron illustrates the fact that the petitioner's "scheme" liability theory is unworkable and fatally flawed. This is significant because petitioner's *amici* repeatedly suggest that *Enron* is the paradigm for how "scheme" liability should work. If *Enron* is the paradigm, then the conclusion is inescapable that "scheme" liability theories are nothing more than dangerous vehicles for allowing clever and resourceful plaintiffs' class action lawyers artfully to recast aiding and abetting claims for exorbitant civil damages against commercial counterparties that played minor roles in transactions mischaracterized by others.

At the outset, it is important to note that Merrill Lynch is being sued for "scheme" liability in *Enron* because of its

commercial activities.[4] Any commercial company can buy or sell an asset (a barge) or a commodity hedge (an energy option). Thus, if Merrill Lynch's commercial activity is a basis for dragging it into a private §10(b) lawsuit about another company's securities, then any commercial counterparty, with hindsight, is potentially subject to a private §10(b) civil claim about another company's securities if it should later turn out that the company engaged in a fraud. This Court has rejected expansions of implied private civil liability under Rule 10b-5 that "could not be easily contained." *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 478 (1977).

Aware of these troubling implications of their "scheme" liability theory, the Regents seek to obscure the problem by suggesting that an implied private cause of action for "scheme" liability is necessary in *Enron* to hold Merrill Lynch and other Banks responsible for statements made by their employees when commenting on Enron's stock in analyst reports. *See* Regents' Br. at 6, 25 n.29, 30.

The Regents misleadingly fail to disclose that the *district court*, which favored "scheme" liability, nonetheless *dismissed* §10(b) claims that were premised on statements of research analysts – on the entirely independent ground that the Regents had not alleged that the specific employees associated with the analyst reports had acted with scienter. *See Enron* Pet. App. 230a-231a; *Southland Sec. Corp.* v. *INSpire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004)

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[4] Because §10(b) makes it "unlawful for *any person* . . . [t]o use or employ . . . any manipulative or deceptive device," 15 U.S.C. §78j(b) (emphasis added), §10(b) liability turns on the activities of the defendant, not whether the defendant is denominated "a lawyer, accountant, or bank," or anything else. *Central Bank*, 511 U.S. at 191. Thus, what matters for purposes of analyzing the Regents' "scheme" claims in *Enron* is that the Regents are suing Merrill Lynch for acting as a counterparty in a commercial transaction, not because Merrill Lynch provided investment banking or underwriting services.

("For purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment."). After that ruling, the Regents also stopped pursuit of another §10(b) claim against Merrill Lynch based on its underwriting activities. The Regents did not cross-appeal the district court's scienter ruling to the Fifth Circuit, or even mention the dismissal of their analyst claims in the court of appeals.

The respondents in *Enron* pointed out all this in their opposition to the Regents' petition for certiorari. *See* Brief in Opposition, *Regents of the Univ. of Cal.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 06-1341, at 10-11 (June 1, 2007). The Regents did not respond to these points in their reply brief. They simply cannot dispute that the Fifth Circuit's rejection of "scheme" liability in *Enron* occurred in the context of Merrill Lynch's commercial activities. The Fifth Circuit's decision does not immunize any entity from private civil liability under §10(b) if, with scienter, it makes material misstatements to the market, including as an analyst or as an underwriter.

A. *Enron* Illustrates That "Scheme" Liability Lacks A Workable Theory Of What Constitutes "Deception" By Commercial Counterparties.

The Regents have conceded, in the questions presented in their certiorari petition and in their amicus brief in this case, that Merrill Lynch "itself ma[de] no affirmative misrepresentations to the market." *Enron* Pet. at i; Regents' Br. at i. Likewise, all the judges on the Fifth Circuit panel in *Enron* and the *Enron* district court agreed that Merrill Lynch owed no duty of disclosure to Enron shareholders given the absence of any fiduciary or special relationship between Merrill Lynch and those investors. *Enron* Pet. App. 15a,

123a.[5] *Enron* illustrates that even after six years of litigation, "scheme" liability lacks a workable theory of what constitutes deception by such a commercial counterparty. The Regents note in passing that the district court in *Enron* spent five years "refin[ing] its rulings regarding scheme liability to 'tighten' the standard." Regents' Br. at 6. This is an unavailing attempt to put a positive spin on the fact that the district court understandably was unable to apply the "scheme" liability theory in a consistent and predictable manner.

Central Bank held that liability under §10(b) is "'an area that demands certainty and predictability.'" 511 U.S. at 188 (quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988)). This is because uncertainty drives up the costs of numerous legitimate transactions and eliminates some altogether. *See* 511 U.S. at 188-89. Yet the record in the *Enron* case graphically illustrates that "scheme" liability inevitably creates "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services." *Central Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652). For example, the claims against Barclays in the *Enron* case initially were upheld, then were dismissed, and then the district court granted the Regents leave to replead those

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[5] Commercial counterparties do not have a duty of disclosure with respect to an issuer's investors because "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980) (referencing "the established doctrine that duty arises from a specific relationship between two parties"). As both the Fifth Circuit and the *Enron* district court agreed, Merrill Lynch and Enron's investors were not "parties to a transaction," and certainly were not in a relationship of trust and confidence. *Regents of the Univ. of Cal.* v. *Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 384 (5th Cir. 2007); *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *101-02 (S.D. Tex. June 5, 2006). The *Enron* case is *a fortiori* one without a duty because Merrill Lynch never engaged in a securities transaction with Enron's investors and the investors were not aware of the Merrill Lynch transactions with Enron.

claims (expressly subject to potential dismissal at the summary judgment stage). The district court explicitly attributed each change of decision to the difficulty of assessing "scheme" liability of secondary actors. *Enron* Pet. App. 678a; *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 439 F. Supp. 2d 692, 713-16, 724 (S.D. Tex. 2006); *Enron* Pet. App. 315a-320a. Indeed, the Regents conceded the inherent uncertainty and shifting contours of "scheme" liability in arguing that the district court should revive their claims against Barclays:

> In its current motion, Lead Plaintiff seeks "a fair opportunity to plead this case *in accordance with the coalescing standard of scheme liability* that is to be ultimately applied in this matter" so as to "*avoid being caught unawares* by refined rules being articulated in the middle of briefing dispositive motions and then applied to pleadings that were crafted ***years before those rules were refined*** . . . ."

Enron Pet. App. 315a (italics added, bold in original).

The district court in *Enron* also first dismissed, then reinstated and then dismissed again the Regents' claims against Deutsche Bank, another counterparty that allegedly participated in the same "scheme." *Enron* Pet. App. 578a-581a, 670a; *Enron* Pet. App. 333a, 344a-364a; *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, No. MDL-1446, 2005 WL 1798423, at *1-*3 (S.D. Tex. July 26, 2005); *Enron* Pet. App. 284a-294a. The Deutsche Bank example is particularly noteworthy because the district court dismissed claims against Deutsche Bank relating to its involvement in LJM2 on the ground that the allegations against Deutsche Bank amounted to no more than aiding and abetting, even though, *unlike* Merrill Lynch, Deutsche Bank (1) served on LJM2's advisory board with respect to LJM2's ongoing operations; and (2) structured transactions involving LJM2. *Enron* Pet. App. 291a. *Compare supra*, at 7. The

inconsistency between the district court's dismissal of the claims against Deutsche Bank relating to LJM2 and the Regents' claims against Merrill Lynch for its more remote association with LJM2 further demonstrates why the vague and overbroad theory of "scheme" liability could never provide the "certainty and predictability" required by *Central Bank*.

B. *Enron* Illustrates That, Contrary To *Central Bank*, "Scheme" Liability Does Not Satisfy The Other Requirements For Primary Liability, Including Reliance and Loss Causation.

Under *Central Bank*, the line between primary liability and aiding and abetting requires that *the defendant's own* "device or contrivance" satisfy *all* of the requirements for primary liability. *Central Bank* states:

> Any person or entity, including a lawyer, accountant, or bank, *who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies* may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

511 U.S. at 191 (first emphasis added; second emphasis in original). Accordingly, in order for a defendant to be liable as a primary violator in a private §10(b) case, that defendant must employ a deceptive device or contrivance that is itself relied on by the plaintiff and that satisfies the other requirements for §10(b) primary liability, including loss causation. A plaintiff cannot mix and match the elements of primary liability by relying upon the conduct of one defendant for some elements and the conduct of another defendant for other elements.

Thus, for example, a plaintiff cannot rely upon a device or contrivance allegedly used by *defendant A* (*e.g.*, an allegedly misleading confirmation to auditors) to satisfy the deception element of §10(b), with a different device or contrivance (*e.g.*, an allegedly misleading financial statement) used by *defendant B* to satisfy the reliance or loss causation elements of primary liability against *defendant A*. The *Enron* case demonstrates that commercial counterparties do not satisfy all of the requirements for primary liability under §10(b) in a private civil case.

1. Reliance: As *Central Bank* held, when a private plaintiff seeking "recovery under Rule 10b-5" cannot establish that he or she relied upon the alleged misstatements or omissions of a particular defendant, the claim against that defendant is no more than a claim seeking to impose aiding and abetting liability:

> [R]espondents' argument would impose 10b-5 aiding and abetting liability when at least one element critical for recovery under 10b-5 is absent: reliance. A plaintiff must show reliance on *the defendant's* misstatement or omission to recover under 10b-5. Were we to allow the aiding and abetting action proposed in this case, *the defendant* could be liable without any showing that the plaintiff relied upon *the aider and abettor's* statements or actions. *See also Chiarella* [v. *United States*], 445 U.S. [222, 228 (1980)] (omission actionable only where duty to disclose arises from specific relationship between two parties). Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.

511 U.S. at 180 (emphases added; citation omitted).

Even if a commercial counterparty were to participate in a "sham" transaction that enabled an issuer to make a misstatement to investors, a plaintiff could only establish that he or she relied on the issuer's misstatement and not on the

actions of the commercial counterparty. For example, in *Enron*, the Regents' claim against Merrill Lynch is premised on the plaintiffs' reliance on the financial statements of the issuer, Enron. *See Enron* Pet. at 25 (asserting reliance because the market "was impacted by the company's falsified financial statements"). This is an aiding and abetting claim barred by *Central Bank*'s requirement that the plaintiffs demonstrate "reliance on *the defendant's* misstatement or omission." 511 U.S. at 180 (emphasis added); *see Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 173-76 (2d Cir. 1998) (because investors relied on the issuer's statements, not on the defendant's false but undisclosed statement, defendant's statement constituted aiding and abetting, not primary liability); *Filler* v. *Hanvit Bank*, 156 F. App'x 413, 415 (2d Cir. 2005) (same ruling applied to bank's undisclosed "sham" transaction and to "false loan confirmations" sent to the issuer's auditor).

2. Loss Causation: The Private Securities Litigation Reform Act of 1995 ("PSLRA") requires that "the *act or omission of the defendant* alleged to violate this title caused the loss" for which the plaintiffs seek damages. 15 U.S.C. §78u-4(b)(4) (emphasis added). Once again, *Enron* illustrates that "scheme" liability for a commercial counterparty does not satisfy "*all* of the requirements for primary liability." *Central Bank*, 511 U.S. at 191 (emphasis in original).

As *Dura Pharmaceuticals* holds, loss causation requires that the issuer's stock price declined because of the revelation of the defendant's deceptive act or omission. 544 U.S. at 344; *see also Ray* v. *Citigroup Global Mkts., Inc.*, 482 F.3d 991, 995 (7th Cir. 2007) ("plaintiffs must show both that the *defendants'* alleged misrepresentations artificially inflated the price of the stock and that the value of the stock declined once the market learned of the deception") (emphasis added); *Lattanzio* v. *Deloitte & Touche LLP*, 476 F.3d 147, 158 (2d Cir. 2007) (plaintiffs failed to allege loss causation because they "have not alleged facts to show that *Deloitte's*

misstatements, among others (made by Warnaco) that were much more consequential and numerous, were the proximate cause of plaintiffs' loss") (emphasis added).

As the district court in the Enron barge criminal case ruled, no loss caused by Merrill Lynch's conduct could be proved under the *Dura* standard. *See supra*, at 10. In the *Enron* civil case, the plaintiffs' experts testified that they did not isolate any stock price decline caused by revelation of Merrill Lynch's transactions, as opposed to revelation of far broader misstatements and omissions by Enron. *E.g.*, Appellants' Record Excerpt No. 11 before the Fifth Circuit at 30973-74 ("5th Cir. R.E."), Dep. Tr. of Scott D. Hakala at 63, 254; 5th Cir. R.E. No. 10 at 30978, 30986, Dep. Tr. of Blaine F. Nye at 540-43, 584-86.[6] Enron's statements and omissions, however, were not "the act or omission *of the defendant*" from which the Regents seek to recover, *i.e.*, Merrill Lynch, which the PSLRA requires the Regents to show in order to establish loss causation as to Merrill Lynch.

It is not surprising, therefore, that the Regents are pursuing a "scheme" liability claim against Merrill Lynch that, they argue, permits loss causation based upon the "conduct of *other* scheme participants about which [Merrill Lynch] knew nothing." *Enron* Pet. App. 194a (emphasis added). That approach, however, flies in the face of the PSLRA's loss causation requirement and with *Central Bank*. It suggests that the courts should create an implied cause of action for conspiracy to violate §10(b), which is directly contrary to the

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[6] The Regents' accounting expert conceded that the challenged Enron transactions that involved Merrill Lynch had only a negligible impact on Enron's financial results. Specifically, he concluded that the barge and energy option transactions accounted for only $7 *million* of Enron's $12.87 *billion* in misstated debt (approximately five one-hundredths of a percent), $62 *million* of the $3.28 *billion* in misstated income (approximately 1.89%), and none of the misstated cash flow (0%). 5th Cir. R.E. No. 6 at 31036-37, 31040-43, excerpts from the February 22, 2006 Supplement to the Expert Report of Saul Solomon.

uniformly accepted view that under *Central Bank* there can be no such cause of action. *See, e.g., Dinsmore* v. *Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 842 (2d Cir. 1998) (concluding that *Central Bank* precludes conspiracy liability under §10(b)); *Glaser* v. *Enzo Biochem, Inc.*, 126 F. App'x 593, 599 (4th Cir. 2005), *cert. denied*, 127 S. Ct. 1876 (2007) (same); *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) (same).

3. "In Connection With": Section 10(b) applies to a particular defendant only if *that defendant* used or employed a deceptive device or contrivance "in connection with" the purchase or sale of a security.[7] In *United States* v. *O'Hagan*, this Court held that §10(b)'s "in connection with" requirement is satisfied only when the consummation of the particular defendant's fraud and "[t]he securities transaction . . . coincide." 521 U.S. 642, 656 (1997).

Assuming, for the sake of argument, that a commercial counterparty's participation in an undisclosed transaction can constitute a "deceptive device or contrivance," that counterparty's conduct stops at that transaction and thus does not "coincide" with any securities transaction. There are at least three intervening steps between the counterparty's conduct and any securities transaction. The first is that the issuer has to prepare false financial statements. The second is that the auditor has to certify those financial statements. The third is that the false financial statements have to be circulated to the public. The "in connection with" requirement would not be satisfied if a commercial counterparty engaged in a "sham" transaction but the issuer ultimately accounted for that transaction properly or never circulated financial statements that were affected by that transaction. *See O'Hagan*, 521 U.S. at 656 (the "fraud is consummated . . .

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[7] *See* §10(b) ("It shall be unlawful for *any person* . . . [*t*]*o use or employ*, in connection with the purchase or sale of any security . . . , *any manipulative or deceptive device* or contrivance . . . .") (emphasis added).

when . . . the information [is used] to purchase or sell securities").

This example demonstrates that the counterparty's liability under the Regents' "scheme" theory depends on and derives from the statements and actions of the issuer. That, in a nutshell, reduces the Regents' claim to nothing more than a claim of aiding and abetting.

C. *Enron* Illustrates That The Gravamen Of A "Scheme" Liability Claim Is Nothing More Than "Aiding and Abetting" With A Different Label.

As previously discussed, the Regents' assertion that Merrill Lynch and other Banks "designed," "devised," "structured" or "contrived" the **Enron** transactions (Regents' Br. at 2, 4, 6, 10-11, 29) is demonstrably false insofar as those allegations are made against Merrill Lynch. *See supra*, at 6-7.

Moreover, the Regents' rhetorical flourishes illustrate the lengths to which resourceful plaintiffs' lawyers will go to avoid the words aid, abet, or assist. Regents' choice of verbs is part of an effort to rewrite §10(b) to reach aiding and abetting. None of the verbs proposed by the Regents is in §10(b). The statute makes it unlawful to "*use or employ* . . . any manipulative or deceptive device or contrivance," *not* to "design or devise" a deceptive device or contrivance. 15 U.S.C. §78j(b)(emphasis added). The Regents cannot change the scope or meaning of the statutory prohibition by changing the nouns "device" and "contrivance" into verbs, or by choosing other verbs that suit their goals better than "use or employ." *See Central Bank*, 511 U.S. at 175 ("the statutory text controls the definition of conduct covered by §10(b)").

Nor is "designed" or "devised" a synonym for "used" or "employed." For example, Hillerich & Bradsby designs the Louisville Slugger baseball bats used by 60% of major league players. But it is the players, not the manufacturer, who use or employ the bats.

Most important, the gravamen of any claim that a commercial counterparty improperly "designed" a commercial transaction is that the counterparty "aided" or "assisted" the issuer in its efforts to issue false financial statements. Thus, whether a counterparty "designed" or merely "participated in" an improper transaction, a plaintiff could not establish key elements of a §10(b) claim against that counterparty, such as reliance or loss causation, by pointing to the counterparty's conduct (as opposed to the issuer's alleged misstatements).

Regardless of which label is used to describe a counterparty's responsibility for an allegedly deceptive transaction (*i.e.*, that the counterparty "designed" or "contrived" that transaction), the plaintiffs' §10(b) claim would fail because the counterparty (1) made no misstatements to the market and had no duty to make disclosures to the issuer's investors; (2) the plaintiffs' loss causation theory would be improperly based on the acts or omissions of the issuer and not on the acts or omissions of the counterparty; and (3) the counterparty's conduct would not have coincided with a securities transaction. As a result, commercial counterparties should not be subject to primary private civil liability under §10(b) regardless of the verb choice of plaintiffs' class action counsel.

D. *Enron* Illustrates That Private "Scheme" Liability Claims, Such As Those Made In This Case, Are Incompatible With The Express Private Causes Of Action In The Securities Statutes.

In *Central Bank*, this Court held that the line between aiding and abetting and primary liability must be carefully defined to ensure that §10(b) private civil liability does not "expand the defendant class for 10b-5 actions beyond the bounds delineated for comparable express causes of action." 511 U.S. at 180. Section 18(a) of the Exchange Act expressly imposes liability on a defendant that "cause[d] to be made" a

misstatement by another party, but expressly requires not only that the plaintiff "purchased or sold a security at a price which was affected by such statement" but *additionally* that the plaintiff made that purchase or sale "in reliance upon such statement" and that plaintiff's loss was caused by the defendant's actions. 15 U.S.C. §78r(a).

Petitioner concedes that a "scheme" liability claim is one against "persons who caused misrepresentations to be made." Pet. Br. at 30. Regents and petitioner, however, did not and could not sue under §18(a) because their "fraud on the market" allegations do not satisfy §18(a)'s requirement that the plaintiffs individually relied upon the defendants' alleged misstatements.[8] *E.g.*, *Heit* v. *Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968); *In re Adelphia Commc'ns Corp. Sec. & Derivative Litig.*, No. 03-CV-5750/5751, 2005 U.S. Dist. LEXIS 43300, at *31 (S.D.N.Y. 2006); *In re MDC Holdings Sec. Litig.*, 754 F. Supp. 785, 798 (S.D. Cal. 1990).

Thus, *Enron* illustrates that a claim that a commercial counterparty, such as Merrill Lynch or the respondents in this case, "caused" the misstatements of an issuer would often fall "beyond the bounds" of §18(a) liability. *Central Bank*, 511 U.S. at 180. Accordingly, the same claim should fail under §10(b). Otherwise, "the defendant class for 10b-5 actions"

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[8] None of the express causes of action available under the federal securities laws, including claims under §§11 and 12 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§77k, 77*l*, and §§9, 16(b), 18 and 20A of the Exchange Act, 15 U.S.C. §§78i, 78p(b), 78r, 78t-1, allows recovery on the basis of "scheme" liability. Nor do the "control person" provisions in §15 of the Securities Act, 15 U.S.C. §77o, and in §20 of the Exchange Act, 17 U.S.C. §78t. Taken together, the absence of "scheme" liability in these express causes of action suggests that Congress did not intend for there to be any form of derivative or secondary liability under §10(b) for persons who did not themselves use or employ a deceptive or manipulative device or contrivance, except for persons who "control" those who did.

would expand "beyond the bounds delineated for comparable express causes of action." 511 U.S. at 180.

E. *Enron* Illustrates The Reality That Commercial Counterparties Are Subject To Numerous Deterrents And Remedies That Make Unnecessary A New Private Cause of Action Under §10(b).

The sum of $109 million paid by Merrill Lynch illustrates that the absence of §10(b) private civil liability for commercial counterparties does not mean that they "get away with" participating in deceptive transactions. They are subject to a variety of express SEC claims, including under §20(e) of the Exchange Act for aiding and abetting. *See also* §17(a) of the Securities Act, 15 U.S.C. §77q (authorizing SEC action against "scheme" participants). They and their employees are subject to federal and state criminal investigation and prosecution. They may be subject to state common law claims for aiding and abetting, where such claims are recognized, and they are subject to enforcement proceedings by state attorneys general.

In any event, this Court has rejected arguments that it should expand the scope of the §10(b) implied cause of action based on policy arguments about deterrence. *See, e.g.*, *Central Bank*, 511 U.S. at 188-90; *Bangor Punta Operations, Inc.* v. *Bangor & Aroostook R.R. Co.*, 417 U.S. 703, 717 (1974) ("If deterrence were the only objective, then in logic any plaintiff willing to file a complaint would suffice. No injury or violation of a legal duty to the particular plaintiff would have to be alleged.").

Similarly, this Court has repeatedly expressed "concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 747-48 (1975); *accord Ernst & Ernst* v. *Hochfelder*,

425 U.S. 185, 214 n.33 (1976). In *Blue Chip Stamps*, the Court recognized and approved the admonition of Chief Judge Cardozo in *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), that courts should hesitate to allow claims that create "a liability in an indeterminate amount for an indeterminate time to an indeterminate class." 421 U.S. at 747-48.

Most importantly, after *Central Bank*, Congress refused to expand the private right of action to deter misconduct by secondary actors. Both the SEC and the private plaintiffs' bar asked Congress to overrule *Central Bank* and extend private civil liability under §10(b) to secondary actors. In enacting the PSLRA in 1995, Congress chose to provide the SEC, but *not* private plaintiffs, with the ability to pursue secondary actors, as the SEC did in *Enron*.

In the PSLRA, Congress specifically granted the SEC authority to bring actions in federal district court for aiding and abetting violations of §10(b) by providing that, in actions brought by the SEC, "any person that *knowingly provides substantial assistance* to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision *to the same extent as the person to whom such assistance is provided*." 15 U.S.C. § 78t(e) (emphases added).

Since 2002, the SEC has used its aiding and abetting and other enforcement authority to recover approximately $8 billion for distribution to investors. SEC, *2006 Performance and Accountability Report* 23 (Nov. 2006), *available at* http://www.sec.gov/about/secpar2006.shtml.

Congress concluded that allowing §10(b) claims by private plaintiffs against secondary actors would undermine the PSLRA's goal of reducing meritless lawsuits. *See* H.R. CONF. REP. NO. 104-369 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 730. The Senate Report summarized the resolution that was codified:

> The Committee considered testimony endorsing the result in Central Bank and testimony seeking to overturn this decision. The Committee believes that *amending the 1934 Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to S. 240's goal of reducing meritless securities litigation.* The Committee does, however, grant the SEC express authority to bring actions seeking injunctive relief or money damages against persons who knowingly aid and abet primary violators of the securities laws.

S. REP. NO. 104-98, at 19 (1995) (emphasis added), *as reprinted in* 1995 U.S.C.C.A.N. 679, 698.[9]

This Court has emphasized that any decision to expand §10(b) private civil liability must be left to Congress. *Central Bank*, 511 U.S. at 176-78, 188-90; *Santa Fe Indus.*, 430 U.S. at 479-80. "The fact that Congress chose to impose some forms of secondary liability, but not others, indicates a deliberate congressional choice with which the courts should not interfere." *Central Bank*, 511 U.S. at 184.

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[9] After Enron collapsed, Congress, in the Sarbanes-Oxley Act of 2002, modified the Exchange Act in several respects, but Congress again declined to extend private civil liability to aiders and abettors, notwithstanding arguments to do so. *See* H.R. REP. NO. 107-414, at 54 (2002); 148 CONG. REC. S6584 (daily ed. July 10, 2002).

CONCLUSION

The decision of the court of appeals should be affirmed.

Respectfully submitted,

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August 15, 2007

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No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR THE NASDAQ STOCK MARKET, INC. AND NYSE EURONEXT AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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IN THE

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No. 06-43

STONERIDGE INVESTMENT PARTNERS, LLC,
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Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR THE NASDAQ STOCK MARKET, INC. AND NYSE EURONEXT AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

INTERESTS OF *AMICI CURIAE* [1]

The Nasdaq Stock Market, Inc., operates The NASDAQ Stock Market LLC (collectively "Nasdaq"), the largest electronic equity securities market in the United States, which lists more companies than any other U.S. market. Nasdaq is a leading provider of securities listing, trading, and information products and services. It is home to approximately 3,200

[1] The parties have consented to the filing of this brief and their letters of consent have been filed with the Clerk. In accordance with Rule 37.6, *Amici* state that this brief was not written in whole or in part by counsel for any party, and no persons other than *Amici* have made a monetary contribution to the preparation or submission of this brief.

listed companies, domestic and foreign, with a combined market capitalization of over $4.6 trillion. Its listed companies represent a diverse array of industries, including information technology, financial services, healthcare, consumer products and industrials. Nasdaq pioneered electronic equities trading more than thirty-five years ago, creating the most replicated market model among global exchanges.

NYSE Euronext, the world's largest exchange group, operates cash equities and derivatives exchanges in the United States and Europe. It is a global leader for listings, equities trading, derivatives, bonds and the distribution of market data. As of June 2007, the total market capitalization of NYSE Euronext's approximately 3,900 listed companies was $30.8 trillion. In the United States, NYSE Euronext operates the markets known as the New York Stock Exchange LLC, the world's largest cash equities exchange based on market capitalization, and NYSE Arca, the first open, all-electronic stock exchange in the United States (collectively, for purposes of this brief, "the NYSE"). For over 200 years, the NYSE has provided a reliable, orderly, and efficient marketplace for investors and traders to buy and sell securities. The NYSE also performs regulatory functions relating to its exchanges and their participants.

Nasdaq and the NYSE are registered with the U.S. Securities and Exchange Commission ("SEC") as national securities exchanges and self-regulatory organizations ("SROs") within the meaning of Section 3 of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(26). The Exchange Act both authorizes and requires SROs to promulgate and enforce rules governing their membership and the conduct of members, member organizations and their employees, 15 U.S.C. §§ 78f(b)(1)-(9), 78s(g), as well as "to remove impediments to and perfect the mechanism of a free and open market . . . and, in general, to protect investors and the public interest." 15 U.S.C. § 78f(b)(5).

SROs in the securities industry are an essential component of the regulatory scheme for providing fair and orderly markets and protecting investors. The Exchange Act imposes on SROs multiple regulatory and operational responsibilities, including day-to-day market and broker-dealer oversight, as well as compliance-monitoring and enforcement of listing standards for listed companies. Virtually all aspects of Nasdaq's and the NYSE's operations are subject to oversight by the SEC.

The rules enforced by Nasdaq and the NYSE as SROs, and those to which they are subject, are focused on safeguarding the integrity of the securities markets and protecting market participants and investors. Nasdaq and the NYSE believe that quality regulation enables them to better serve listed companies, market participants and investors in providing high quality cash equities markets, access to deep pools of liquidity, and fast and transparent trading data and execution. This in turn enables the corporate growth, entrepreneurship, and innovation that are the hallmarks of the U.S. capital markets.

Nasdaq and the NYSE are acutely aware that the globalization of world markets and an increasingly competitive global environment for equity capital are challenging the United States' historical dominance in capital markets. Companies worldwide, with newly viable alternative venues for listing, launching IPOs, investing, and doing business, have voiced concerns to Nasdaq and the NYSE regarding the litigation climate generally in the United States and the potential expansion of third-party liability.

Nasdaq and the NYSE share an interest in an application of the securities laws that is faithful to the limitations imposed by Congress and this Court's prior decisions. In particular, Nasdaq and the NYSE believe that current and potential issuers (whether located in the United States or abroad) must not be dissuaded or inhibited from utilizing the U.S. capital markets by unreasonable and unpredictable extensions of

securities fraud liability to third parties providing services to such issuers. Nasdaq and the NYSE believe that the boundaries of who might be held potentially liable under the antifraud provisions of the Securities Exchange Act of 1934 should be clear and unambiguous, and that interpretations of those provisions that risk unbounded expansion of potential liability inhibit growth of and access to the U.S. capital markets.

For the reasons discussed more fully in this brief, Nasdaq and the NYSE respectfully urge the Court to affirm the decision below.[2]

SUMMARY OF ARGUMENT

The United States public equity markets have long offered the most liquid, most competitive and best regulated pools of equity capital in the world. Public listing of companies on U.S. stock exchanges, under the regulatory mechanisms created by U.S. securities law, has greatly benefited U.S. investors and contributed to U.S. economic growth. But the globalization of world markets and an increasingly competitive global environment for equity capital are challenging the United States' historical dominance in capital markets. Companies worldwide, with newly viable alternative venues for listing, are increasingly launching IPOs, investing, and doing business outside the United States.

In this environment, increasing the costs of doing business with U.S. public companies weakens the competitiveness of the U.S. public equity capital markets and thus harms U.S.

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[2] NYSE Euronext is one of several defendants in a pending purported class action litigation asserting securities and antitrust law violations, styled *Sea Carriers, LP I et al. v. NYSE Euronext et al.*, No. 07 Civ. 4658 (S.D.N.Y.) (filed June 1, 2007). Although that complaint does not relate to NYSE Euronext's role as an issuer, an affirmance of the Eighth Circuit's decision below could benefit NYSE Euronext and other defendants in that matter.

investors and the U.S. economy. Petitioner's novel theory would impose such costs by extending private Section 10(b) liability to manufacturers, vendors and suppliers who merely do business with a publicly traded company that later makes a misstatement or material omission to its investors. Such a novel theory of liability would make one company responsible for another company's accurate accounting and reporting, thus converting business counterparties effectively into auditors and insurers of compliance with the securities laws. Counterparties thus will either avoid doing business with publicly traded companies or charge them more for doing so.

This approach is highly inefficient, and the costs it imposes are likely to discourage companies from listing or remaining on U.S. public stock exchanges and encourage their relocation to increasingly competitive foreign markets. Thus, far from increasing enforcement of the U.S. securities laws, Petitioner's theory, if adopted, would have the perverse effect of shrinking the scope of their coverage.

Such increased costs and their attendant harms to U.S. public equity markets, U.S. investors and the U.S. economy are unnecessary. Congress has created and periodically enhances a complex and overlapping set of protections for investors in U.S. publicly traded companies that provides adequate protection without need for new, judicially fashioned private causes of action.

Congress knows well how to add aiding-and-abetting or participant liability to this enforcement mosaic, and has done so in several narrowly defined circumstances. But Congress has never enacted the expansive, unlimited participant liability sought by Petitioner, even when specifically urged to do so by the SEC and others. Against this legislative backdrop, judicial creation of such liability would be inappropriate. The complex weighing of any marginal gain in deterrence from such new private Section 10(b) liability against the costs to U.S. public companies, their counterparties, and the competi-

tiveness of the U.S. public equity capital markets is quintessentially a matter of policy that should be left, if at all, to Congress and not the courts.

ARGUMENT

I. CREATING NEW PRIVATE SECTION 10(b) LIABILITY FOR ENTITIES THAT DO BUSINESS WITH PUBLICLY TRADED COMPANIES WOULD RAISE THE COST OF LISTING ON U.S. EXCHANGES, WEAKENING THE GLOBAL COMPETITIVENESS OF THE NATION'S PUBLIC EQUITY CAPITAL MARKETS

The United States has long been recognized as having the world's largest, most liquid, and until recently, most competitive public equity capital markets. Both American and foreign corporations historically have turned to these markets as principal sources for raising and pricing capital. Strong public equity capital markets stimulate other sources of capital formation; the venture capital industry, for example, invests in start-up companies based on the prospect that the most successful of them may be taken public.[3] And the contribution of strong capital markets to overall economic growth is well documented.[4]

The historical success of the nation's public equity capital markets has depended greatly on a strong system of securities regulation and self-regulation. "Tough enforcement is essential for a strong securities market," and "[t]he United States has the toughest administrative enforcement of securities laws

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[3] *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

[4] *See* Ross Levine & Sara Zervos, *Stock Markets, Banks and Economic Growth*, 88 AM. ECON. REV. 537 (1998).

in the world."[5] The securities laws adopted by Congress in the wake of the market crash of 1929 represent a remarkable regulatory success story. The Securities Act of 1933 increased disclosure of the financial conditions of publicly traded corporations, making the public securities markets much more transparent. The Securities Exchange Act of 1934, and in particular, Section 10(b) of that Act, were aimed at preventing unfair conduct in the trading of public securities.

Section 10(b) was *not* aimed, however, at regulating the conduct of those who merely conduct commercial transactions with companies listed on public equity capital markets. To the contrary, the Exchange Act sought in a targeted way "to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges." H.R. REP. NO. 73-1383, at 2 (1934). Congress aimed to prevent, for example, securities price manipulation by market actors such as brokers, dealers, syndicates, financial writers, and insiders. Nothing in the Exchange Act's enactment reflected a concern with regulating commercial transactions in which securities issuers engaged in the ordinary course of their businesses. As this Court has often reiterated, the securities laws are not a general code of corporate conduct. *See, e.g.*, *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.").

Disregarding this history and these principles, Petitioners seek here to establish a private right of action under Section 10(b) against those who do business with a publicly traded

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[5] COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 71-72 (2006) ("INTERIM REPORT"), *available at* http://www.capmktsreg.org/research.html.

corporation that misrepresents the parties' transaction to its shareholders—even where the issuer's counterparty makes no misstatement itself, and violates no fiduciary duty to the public issuer or its investors. Such a theory has twice been definitively rejected—once by this Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which held that a private plaintiff may not maintain an aiding and abetting action under Section 10(b), and once by Congress, which pointedly declined to create such private liability despite the SEC's express recommendation that it overturn *Central Bank* by doing so. Congress instead granted the SEC, and only the SEC, authority to prosecute aiding and abetting of Section 10(b) violations in Section 20(e), 15 U.S.C. § 78t(e), a provision added by the Private Securities Litigation Reform Act (PSLRA).[6] The theory of private liability sought here and correctly rejected by the decision below is a transparent end run around these considered decisions by two branches of government.

Among the many reasons to reject Petitioner's argument is the significant harm its novel private liability theory would cause to publicly traded companies. Public listing of companies on stock exchanges like Nasdaq and the NYSE has benefited the nation's economy by enabling a high volume of securities trading within a sophisticated legal structure that

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[6] After *Central Bank* was decided, the SEC and others called for legislation overturning the decision, and Congress held several hearings on the subject. *See Aiding and Abetting Liability under the Federal Securities Laws: The Impact of the Supreme Court's Decision in Central Bank: Hearing Before Subcomm. on Securities of the Sen. Banking, Housing, and Urban Affairs Comm.*, 103rd Cong. (1994); *Private Securities Litigation Revision: Hearing on H.R. 10 Before Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 104th Cong. (1994). Congress, however, determined that "amending the 1934 Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to [the PSLRA's] goal of reducing meritless securities litigation," S. REP. NO. 104-98, at 19 (1995).

protects investors and businesses alike through administrative enforcement by the SEC and self-regulation by the SROs. The benefit of listing on U.S. exchanges also includes the periodic and offering disclosure obligations established and reviewed by the SEC. Imposition of inefficient and inappropriate costs on publicly traded companies through adoption of Petitioner's theory would diminish these benefits by discouraging companies from listing or remaining on U.S. public stock exchanges.

Thus, ironically, Petitioner's purported effort to increase the private enforcement of the securities laws might well have the perverse effect of decreasing the volume of securities business subject to those laws as companies seek to raise capital through public listings abroad or private alternatives.

A. Petitioner's Theory Would Impose Costly Audit or Insurance Obligations on Those Who Do Business with Publicly Traded Companies

As the complaint in this case illustrates, Petitioner's theory of implied participant liability under Section 10(b) would greatly increase the risk that accompanies doing business with companies traded on U.S. public stock exchanges. Petitioner, an investor in publicly traded securities issued by Charter Communications, does not allege that Motorola or Scientific-Atlanta made any misstatements or omissions upon which it relied in connection with the purchase or sale of those securities, nor that Motorola or Scientific-Atlanta owed Charter or its investors any fiduciary duty of disclosure. Petitioner does not allege that Motorola or Scientific-Atlanta improperly accounted for or misreported the supposedly "sham" transactions. Petitioner alleges only that it relied upon false statements by Charter concerning its financial performance, which Charter was able to report because of its previous commercial transactions with Motorola and Scientific-Atlanta.

Petitioner thus seeks to impose private liability on Respondents solely for another company's failure to account for and report their mutual commercial transactions properly. Such liability would add a burdensome obligation in addition to those already imposed by the securities laws. Under existing Section 10(b) rules, a public company may engage in a wide range of transactions with counterparties based solely on business considerations, so long as those transactions are properly accounted for and accurately reported by the company to the investing public. Under Petitioner's theory, however, counterparties would risk civil damages liability if they failed to ensure that the publicly traded company with whom they were doing business was also properly accounting for and accurately reporting those transactions. Such potential liability could lack any proportion to the business transaction at issue.

Faced with such potential liability, a commercial vendor or purchaser has three choices. *First*, it can increase its due diligence with respect to its commercial transactions with a publicly traded company in order to decrease its risk of exposure if that company later fraudulently accounts for those transactions. Implementing this due diligence would effectively transform a business relationship into an auditing relationship.

This approach is likely to be highly inefficient. By analogy, firms that are already subject to the reach of securities liability, such as underwriters for a newly offered company, engage in a significant, costly and time-consuming legal and financial due diligence review of the company, its management and its statements in the offering document. Even a pared-down version of this diligence review would take time, slowing the ability of public companies to sign contracts and making them less competitive with their private and foreign counterparts. On Petitioner's theory, a business transaction would not be complete when a contract is performed but

would require ongoing surveillance until the public company's quarterly or annual reports were filed. Such an approach would also undermine the division of labor within corporations. Sales employees, acting in a non-accounting role and without expertise in the preparation or issuance of financial statements, could subject their companies to litigation risk merely by engaging in a business transaction that was later improperly accounted for or reported by the financial employees of a public company with whom they did business—employees wholly uninvolved in the underlying sales transaction.

Second, a commercial vendor or purchaser that does business with publicly traded companies can insure against the risk that those companies will fraudulently report transactions. It can do so by increasing formal insurance coverage. Or it can self-insure by charging higher prices to do business with publicly traded companies.

The cost of such insurance or self-insurance could well be significant given the litigation features of Petitioner's theory. This Court has acknowledged in general "that 'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 80 (2006) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). The risk of vexatiousness is likely to be especially high on the theory urged here. "Participation" with a supposed "purpose and effect" to advance a fraud is easy to allege and difficult to dismiss without factual development, increasing incentives to settle even the most baseless or attenuated participation claims. Moreover, awards risk being dramatically disproportionate to the economic value of the transaction. In these circumstances, the cost of insurance is necessarily increased because it is difficult to price such broad and unrelated risks.

The *third* alternative for commercial counterparties fearing liability from their transactions with publicly traded U.S. companies is to shift their business away from publicly traded U.S. companies altogether. This alternative would reduce the profitability and competitiveness of publicly traded U.S. companies. For example, if a producer of a component who could sell to either a U.S. or a foreign manufacturer chooses to avoid Section 10(b) participant liability risk by choosing the foreign manufacturer, the foreign manufacturer will gain a competitive advantage over the U.S. manufacturer in selling the finished product back into the United States. Even if they do not take their business overseas, vendors might forego otherwise efficient transactions because the litigation risk is too great in relation to the small size of the contract or the contract too likely to be deemed material to the issuer.

Under all three of these scenarios, adoption of Petitioner's theory would increase the cost of doing business with publicly traded U.S. companies. These costs in turn increase the cost of *being* a publicly traded U.S. company. Service providers will charge more for their services; margins will be lower; and business will be lost. In short, the economic effect of turning commercial counterparties into auditors or insurers of a publicly traded U.S. company's securities compliance would be to decrease the incentive to remain or list on a U.S. public exchange in the first place.

B. Increasing the Cost of Doing Business with Publicly Traded U.S. Companies Encourages Flight to Foreign Equity Markets, Which Offer Increasingly Competitive Alternatives

In a closed system, increasing the cost of listing on a U.S. public stock exchange might leave companies with little alternative but to list there anyway and absorb the increased cost. But the global environment for equity capital has

become increasingly competitive. As governments in Europe and Asia have liberalized and modernized their capital markets, foreign markets are becoming robust alternatives to public exchanges based in the United States. Hong Kong, Singapore and Europe now have highly competitive stock exchanges. This new environment poses greater risk that increasing the cost of a U.S. public listing—as Petitioner's theory would entail—will encourage companies to raise capital abroad instead.

For example, U.S. capital markets are now growing at just over half the rate of foreign markets, with overall market capitalization in major foreign markets growing at ten percent a year, compared with a growth rate of six percent in the United States.

The United States is also now lagging foreign markets in the creation of new companies. In the 1990s, the number of foreign companies choosing to list on the NYSE and Nasdaq increased roughly fourfold, while European exchanges lost market share. Over the past decade, however, "the trend seems to have reversed."[7] Initial public offerings (IPOs) on U.S. exchanges have fallen from over forty percent of global capital to just seventeen percent. In 2006, twenty-three of the largest twenty-five IPOs chose to list outside the United States, meaning that only two of the top twenty-five IPOs listed on U.S. exchanges; in 2005, the number was one. Companies seeking access to U.S. investors have increasingly done so through non-U.S. capital pools; for example, U.S. institutional and retail investors have recently been increasing their holdings of non-U.S. investments by fourteen percent annually while increasing holdings of U.S. investments by only eight percent.

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[7] INTERIM REPORT, *supra* note 5, at 29.

In light of these trends, several recent major studies have concluded that the U.S. public equity market is losing competitiveness with foreign markets.[8] As countries compete with one another for pools of capital, one dimension of their relative competitiveness is litigation risk and the perception of such risk. As one study summarized, "certainly one important factor contributing to this trend is the growth of U.S. regulatory compliance costs *and liability risks* compared to other developed and respected market centers."[9]

While these concerns should not be overstated, and the $20 trillion U.S. equity capital pool remains the largest in the world, the growth of competition from foreign stock exchanges means that new litigation exposure that increases the cost of being a U.S. publicly traded company may tip the balance in a company's choice of where to list.[10] Such disincentives to public listing of equities on U.S. exchanges risk harming U.S. investors and the U.S. economy.

* * *

In sum, while it might seem at first glance that Petitioner's theory would increase enforcement in the public securities markets, imposing some increased cost on counterparties of public issuers but neutral in its effects on public issuers themselves,[11] such a view would be mistaken. Adoption of Peti-

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[8] *See id.*; MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP ii, 5, 12, 43-54 (2006), *available at* http://www.tinyurl.com/ 2fhyuf.

[9] INTERIM REPORT, *supra* note 5, at x (emphasis added).

[10] *See* BLOOMBERG & SCHUMER, *supra* note 8, at 16-17 (noting that "legal environment" and "regulatory balance" are the key factors after workforce quality in determining a financial center's competitiveness).

[11] Many counterparties on whom Petitioner's theory would impose new liability are in any event, as here, publicly traded companies, so that the costs would be borne by public investors either way.

tioner's novel private liability theory would impose increased costs on publicly traded companies and thus would encourage shifts at the margin to foreign (and private) alternatives. The net effect would be perversely to reduce the scope of coverage of U.S. securities laws rather than to improve their enforcement, risking harm to U.S. investors and the U.S. economy.

II. CREATION OF ANY NEW PRIVATE SECTION 10(b) "PARTICIPANT" LIABILITY SHOULD BE LEFT TO CONGRESS

As this Court recently stated, "it is the federal lawmaker's prerogative . . . to allow, disallow, or shape the contours of . . . § 10(b) private actions." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2512 (2007). Private liability under the securities laws is "'an area that demands certainty and predictability,'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)), and clear statements by Congress serve these important values better than judicial creation of any new "complex, sinuous line separating securities-permitted from securities-forbidden conduct," *Credit Suisse Sec. (USA) LLC v. Billing*, 127 S. Ct. 2383, 2397 (2007).

It is especially appropriate to leave undisturbed Congress's decision not to create new private Section 10(b) liability for commercial participants in transactions with publicly traded companies, for three reasons:

First, as this Court noted in *Central Bank*, Congress knows how to impose aiding-and-abetting liability when it wishes to. Because Congress pointedly declined to provide for private aiding-and-abetting liability in the wake of *Central Bank*, judicial implication of such a claim here would be inappropriate. Judicial creation of a new private right of action under the label of "participant" scheme liability would be similarly inappropriate, for Congress has provided for "participant"

liability in several narrowly defined circumstances in the securities laws while pointedly omitting it from Section 10(b).

Second, Congress's institutional fact-finding capacity makes it better suited than the courts to weigh the complex economic tradeoffs involved in extending private Section 10(b) liability to remote actors who are merely commercial counterparties. *Third*, securities fraud is policed by various mechanisms other than private lawsuits under Section 10(b) that obviate the need for any judicial implication of new civil remedies pending any future congressional action.

A. By Providing for Specific "Participant" Liability in Other Securities Laws But Not in Section 10(b), Congress Has Precluded Implied Section 10(b) Participant Liability

The text and structure of the federal securities laws resist judicial implication of a private cause of action for "participation" in a commercial transaction that later results in securities fraud by a public company. Congress in the 1930s was well aware of the concept of participant liability and employed it selectively in parts of the securities laws while contemporaneously omitting it from Section 10(b). Where Congress has expressly provided for something in one provision of the securities laws and omitted it in another, that omission generally is considered intentional. *See, e.g., Touche Ross & Co. v. Redington*, 442 U.S. 560, 571-72 (1982).

Before the enactment of federal securities laws in the 1930s, state "blue sky" laws recognized narrow variants of participant liability. Section 16 of the Model Uniform Sale of Securities Act, for example, authorized suit against any "director, officer, or agent" of a seller who "personally participated in or aided in any way" a fraudulent security sale.[12]

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[12] *See* Douglas E. Abrams, *The Scope of Liability under Section 12 of the Securities Act of 1933: 'Participation' and Pertinent Legislative Materials*, 15 FORDHAM URB. L.J. 877, 926 (1987). By the time that the

Section 15 of the Uniform Act also authorized injunctive relief against any "person or persons . . . in any way participating in . . . fraudulent practices or acting in violation" of the Act.[13]

Against this state-law backdrop, Congress authorized several specific, narrow versions of participant liability in both the 1933 Act and the 1934 Act. For example, the 1933 Act allows liability against an underwriter involved with a security for which a false registration is issued, *see* 15 U.S.C. § 77k(a)(4), and defines the term "underwriter" to include anyone who "participates or has a direct or indirect participation" in the distribution of a security, *id.* § 77b(a)(11). Similarly, Section 9 of the 1934 Act imposes liability upon "[a]ny person who willfully participates in any act or omission" that violates that section, which prohibits certain types of market manipulation. 15 U.S.C. § 78i(e). Various other provisions of the securities laws also impose liability for participation in certain specific and narrowly defined circumstances.[14]

By contrast, there is nothing in Section 10(b) that provides for participant liability. The section does not impose liability upon "participants" in underlying commercial transactions or other activities remote from the securities market. Instead, Section 10(b) makes it unlawful to "use or employ" any deceptive or manipulative device "in connection with" the purchase or sale of a security. 15 U.S.C. § 78j(b). As this Court has recognized, these elements require that the deceptive or manipulative device "coincide" with the purchase or

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Exchange Act was enacted in 1934, at least twelve states and Hawaii had adopted such participant liability. *See id.* at 926-27.

[13] By early 1933, this provision had been adopted verbatim by at least three states and Hawaii. *See id.* at 926 n.292.

[14] *See id.* at 932-34 (Trust Indenture Act); *id.* at 934-36 (Investment Company Act); *id.* at 936-37 (Investment Advisers Act); *id.* at 937-40 (Section 11 of the 1933 Act).

sale of securities. *SEC v. Zandford*, 535 U.S. 813, 822 (2002). Participation that merely facilitates fraudulent statements by another party concerning that party's securities at some point in the future cannot fit this legislative text or structure.

Where Congress has so carefully picked and chosen its spots in the securities law to impose narrow and carefully specified participant liability, judicial implication of newly expanded participant liability Congress has not chosen would be inappropriate. This Court recognized as much in *Pinter v. Dahl*, 486 U.S. 622 (1988), where it rejected the petitioner's contention that Section 12 of the 1933 Act imposed liability on any individual whose participation in the sale of securities was a substantial factor in causing the fraudulent sale to occur. The Court observed that Congress was aware of collateral participation concepts but had not chosen to implement them in Section 12. *See id.* at 650-51. *Pinter* thus supports the idea that it is only the participants specified in the statute that are covered.

Here, too, it should not be assumed that Congress simply forgot to mention in Section 10(b) that it had intended to permit a broad private cause of action for participant liability. Because Congress included narrowly defined participant liability in Section 9, an adjacent statutory provision, it is more plausibly concluded that Congress considered and rejected such liability under Section 10(b).

B. Congress Is Better Suited than the Courts to Weigh the Costs and Benefits of Creating Section 10(b) "Participant" Liability

Whether Petitioner's proposed private right of action will, as argued above, invite wasteful strategic litigation, increase the cost of doing business with publicly traded companies and endanger the competitiveness of U.S. public equity capital markets are quintessential policy questions best suited for

careful fact-finding and systematic review. So is the question whether any possible marginal gains to deterrence could justify such costs. Such tasks are best assigned to Congress, whose broad oversight of the national economy allows it to assess the facts and make the relevant tradeoffs.

C. Existing Regulatory Mechanisms Established and Enhanced Periodically By Congress Make Implication of Expansive Private "Participant" Liability under Section 10(b) Unnecessary

Congress has provided an extensive regulatory system that obviates the need for judicially created "participant" scheme liability such as Petitioner seeks here. That structure has an array of protections beyond private lawsuits, including administrative enforcement by the SEC, criminal enforcement by the Department of Justice, and self-regulation by the SROs. Congress has regularly supplemented these regulatory powers when needed, and can specify new forms of participant liability if it sees fit in the future.

For example, federal criminal prosecution of securities law violations has increased markedly since the 2002 creation of the Corporate Fraud Task Force within the Department of Justice. Moreover, the SEC's administrative enforcement power has been increased by recent legislation, most notably by the FAIR Funds Act's establishment of a fund through which over $8 billion has been collected for the purpose of disgorgement to investors and payment of civil penalties. *See* 15 U.S.C. § 7246. Regulation may be extended where appropriate beyond immediate securities market actors; as noted above, the PSLRA conferred upon the SEC the authority to prosecute aiding and abetting of Section 10(b) violations.

The authorities exercised by private SROs are another component of the complex, overlapping mosaic of protection that investors enjoy under the federal securities laws. The concept of self-regulation was, from its inception, a corner-

stone of federal oversight of the securities and futures industries. The Securities Exchange Act of 1934 authorizes SROs to promulgate and enforce rules governing their membership and the conduct of members, member organizations and their employees, 15 U.S.C. §§ 78f(b)(1)-(9), 78s(g). SROs are also required "to remove impediments to and perfect the mechanism of a free and open market . . . and, in general, to protect investors and the public interest." 15 U.S.C. § 78f(b)(5). Congress's delegation of authority to SROs creates an overlapping system of market protection that uses valuable, expert, front-line oversight by industry-dedicated professionals to supplement regulatory enforcement and help meet the challenges posed by the size, complexity and pace of the public equities markets.

Other advantages of self-regulatory authority are the flexibility to address new unfair or manipulative trading practices and the ability to set standards that exceed those imposed by the SEC—for example, to preclude conduct detrimental to the market and contrary to equitable principles of trade.[15]

SROs such as Nasdaq and the NYSE provide several forms of self-regulation. They regulate the conduct of their members through an independent non-governmental body, the Financial Industry Regulatory Authority (FINRA), formed in 2007 through the consolidation of the National Association of Securities Dealers (NASD) and certain regulatory functions of the NYSE, including its enforcement arm. In addition, the SROs themselves, with the approval and oversight of the SEC, set standards and ascertain eligibility for companies listing on their exchanges. While they do not duplicate the audit function, they regularly review their listed companies' compliance with financial and governance listing standards. This monitoring function also enables the enforcement of the

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[15] *See generally* S. REP. NO. 73-1455 (1934); H.R. DOC. NO. 73-1383, 2d Sess. (1934).

exchanges' disclosure obligations and early detection of issues that might give rise to a public interest concern.

SROs wield enforcement authority including the ability to halt trading and the ultimate sanction of delisting public companies from their exchanges. Delisting may occur for several reasons, including the failure to maintain the quantitative standards required by rule, timely file periodic reports, or meet required corporate governance standards such as obtaining requisite shareholder approvals or maintaining audit committee independence. An issuer may also be delisted when the exchange determines it has acted contrary to the public interest, even if the issuer meets all enumerated criteria for listing.

Congressional support for the SRO system is evident in its periodic reexamination of SRO powers, reaffirmation of the system, and expansion of SRO authority when needed.[16] For example, the Sarbanes-Oxley Act of 2002 mandated stricter audit committee corporate governance listing standards. Congress has determined these expansions of authority to be appropriate because SROs, like the SEC, have a comparative advantage over private securities plaintiffs in expertise and systematic knowledge of the markets.

This complex and overlapping set of protections, subject to periodic congressional review and enhancement, needs no supplement from new and unbounded private rights of action for "participant" liability.

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[16] *See, e.g.*, U.S. SEC. EXCH. COMM'N REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95 1st Sess. (1963); U.S. SEC. EXCH. COMM'N, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS, Division of Market Regulation, U.S. Securities and Exchange Commission (1994).

CONCLUSION

The decision below should be affirmed.

Respectfully submitted,

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No. 06-43

In The Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

BRIEF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF THE *AMICUS CURIAE*[1]

The National Association of Manufacturers (the "NAM") is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards. In support of this mission, the NAM regularly files briefs *amicus curiae* in this Court and other courts.

The NAM does not condone securities law violations or deceptive conduct in any form or for any purpose. Nevertheless, the NAM opposes the position of Petitioner in this case. The expansive and nebulous theory of scheme liability advocated by Petitioner in this case lacks any basis in the statutory text or the Court's precedent and threatens to ensnare law-abiding manufacturers in the costly web of securities class action litigation based on the conduct of those with whom they do business. Were the Court to adopt such a theory, American manufacturers would be exposed to a greatly increased risk of frivolous securities fraud litigation. Legitimate commerce would be chilled both by the uncertainty inherent in Petitioner's proposed standard and by the heavy cost of defending against frivolous securities litigation claims, undercutting the competitiveness of the U.S. economy. American manufacturers can succeed only if the rules governing their

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[1] This *amicus* brief is filed with all parties' consent. No counsel for any party authored this brief in whole or in part, and no person or entity other than *amicus*, its members and its counsel made a monetary contribution to the preparation or submission of this brief.

potential liability are clear, as they have been under this Court's jurisprudence for the past several decades. The NAM seeks to preserve this clarity for its members.

SUMMARY OF THE ARGUMENT

Petitioner urges this Court to dramatically expand the private right of action under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). Under Petitioner's proposed "purpose and effect" test, anyone allegedly participating in a "scheme to defraud" investors can be held liable under Section 10(b), regardless of whether that actor had any contact with those investors or owed them any duty. In arguing that the conduct of such actors is encompassed by Section 10(b), Petitioner ignores the language of the statute that explicitly limits its reach. Petitioner also ignores this Court's precedent, including *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which prohibited private rights of action against peripheral actors for the type of aiding and abetting conduct that Petitioner now seeks to capture under the rubric of "scheme liability."

The broad expansion of actors subject to primary liability under Section 10(b) that Petitioner seeks is inconsistent with the statute's requirement that liability be based on the use or employment of a deceptive device that occurs "in connection with the purchase or sale of any security." The "in connection with" requirement, as repeatedly construed by this Court, limits the reach of private civil actions under Section 10(b) to defendants whose conduct necessarily requires or is dependent upon a securities transaction. Thus, only those parties that make a disclosure to investors, owe investors a specific fiduciary duty or engage in insider trading can satisfy the "in connection with" requirement. By contrast, those parties

who engage in commercial transactions with an issuer of securities, such as the sale of goods and services, have not acted in connection with a purchase or sale of securities. They make no disclosures to their purchasers' shareholders, owe them no fiduciary duty, and do not engage in insider trading. Under these circumstances, manufacturers should not be subject to liability under Section 10(b). Nevertheless, Petitioner's "purpose and effect" test seeks to impose such liability on this broad category of companies and individuals.

Petitioner's "purpose and effect" test also ignores Section 10(b)'s requirement that a defendant "use or employ" a deceptive device in connection with a purchase or sale of securities. This requirement limits Section 10(b) liability to persons or entities who take an affirmative action that deceives investors. In this case, and in numerous other cases alleging "scheme liability," the vendor or purchaser of goods did not interact with the issuer's investors at all and, thus, did not "use or employ" a deceptive device against them. Allegations that a third party assisted a public company that itself used or employed a deceptive device against its own shareholders do not give rise to primary liability against the third party. Instead, the third party may be held liable only for aiding and abetting in a claim brought against it by the SEC.

Petitioner also ignores the well-established principle that an actor cannot be liable for a Section 10(b) violation unless it breaches a duty to investors. Such a duty can be based on an existing fiduciary relationship between an actor and investors or can arise by virtue of a statement that the actor makes to investors. Here, as in many scheme liability cases, Petitioner does not allege either that Respondents made any misstatement to Charter's shareholders or that they owed them any other duty. Alleging that Respondents

acted as part of a "scheme" is insufficient to subject them to Section 10(b) liability without the requisite duty.

Petitioner's broad scheme liability theory is not only contrary to precedent but it also is at odds with sound public policy. The "purpose and effect" test proposed by Petitioner would lead to great uncertainty among manufacturers and others who do business with issuers of securities concerning their potential securities fraud liability. This ambiguity in an area of the law with enormous potential liability contravenes the well-established goal of this Court to promote certainty and predictability.

Moreover, were the Court to adopt the "purpose and effect" test, plaintiffs would invariably barrage manufacturers and sellers of products with securities fraud lawsuits every time they engaged in commerce with a public company that improperly accounted for, or failed to correctly describe, a transaction with them. The vagueness inherent in the "purpose and effect" test would make it difficult, if not impossible, for such third parties to obtain dismissal of these claims under Rule 12(b)(6). Therefore, third party manufacturers and sellers would be forced to expend considerable sums defending themselves in securities litigations where they neither made any statements nor owed any duties to the investor class. The heavy costs involved in defending these suits would allow plaintiffs to coerce settlements. Additionally, the elevated risk of incurring such costs and the potential imposition of securities fraud liability would significantly increase the costs of doing business for America's manufacturers, vendors and providers of goods and services. Such an outcome would make American companies less competitive, harm the domestic economy and discourage foreign companies from doing business with domestic companies, resulting in higher prices and fewer choices for American consumers.

In sum, Petitioner's scheme liability theory is contrary to the language of Section 10(b), decades of precedent and sound public policy. It is nothing but an attempt to revive aiding and abetting liability under a different name. The Court should affirm the decision of the Eighth Circuit and reject Petitioner's attempt to rewrite the securities laws.

ARGUMENT

I. PETITIONER'S PROPOSED "PURPOSE AND EFFECT" STANDARD FOR IMPOSING SCHEME LIABILITY IGNORES THE CLEAR LANGUAGE OF SECTION 10(b) AND WOULD CONSTITUTE A DRAMATIC DEPARTURE FROM ESTABLISHED PRECEDENT

A. Any Claim Asserted Under Section 10(b) Or Rule 10b-5 Must Satisfy The "Use Or Employ" And "In Connection With" Requirements

Section 10(b) of the Exchange Act makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o *use or employ, in connection with the purchase or sale of any security*, . . . any manipulative or deceptive device or contrivance. . . ." 15 U.S.C. § 78j (2007) (emphasis added). These "use or employ" and "in connection with" requirements apply to any Section 10(b) claim, whether or not it alleges scheme liability under Rule 10b-5(a) and (c).[2]

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[2] *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994) ("[A] private plaintiff may not bring a [Rule] 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)."); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (same); *United States v. O'Hagan*, 521 U.S. 642, 651 (1997) ("Liability under Rule 10b-5 . . . does not extend beyond conduct

(Continued on following page)

Additionally, *Central Bank* makes clear that a plaintiff can hold a defendant liable as a primary violator only if the conduct of *that* defendant satisfies "all of the requirements" of Section 10(b). 511 U.S. at 191. A plaintiff cannot "borrow" an element of Section 10(b) liability from one defendant and apply it to another defendant. Accordingly, to maintain a claim against multiple defendants, a plaintiff must show that *each* defendant acted "in connection with the purchase or sale" of a security and that *each* defendant "used or employed" a deceptive device in so doing.

While Petitioner and its *amici* claim to base their argument on the plain language of Section 10(b), they fail to consider these important statutory elements. Instead, they ask the Court to interpret the word "deceptive" in a vacuum. Petitioner's interpretation of "deceptive" contradicts the clear statutory language of Section 10(b) when the word is considered in context.

B. The "In Connection With" Requirement Is Satisfied Only If A Defendant's Fraudulent Actions Necessarily Required Or Depended Upon A Securities Transaction

To satisfy the "in connection with" requirement, a defendant's conduct must "touch" upon or "coincide" with a securities transaction. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971) ("The crux of the present case is that [plaintiff] suffered an injury as a result of deceptive practices touching its sale of securities as an investor."); *Zandford*, 535 U.S. at 820 ("[R]espondent's fraud coincided with the [securities] sales. . . .").

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encompassed by § 10(b)'s prohibition."); *S.E.C. v. Zandford*, 535 U.S. 813, 816 n.1 (2002) (same).

This Court's precedent demonstrates that the terms "touch" and "coincide," and the concept of dependence, are not trivial or *de minimis* standards reaching any conduct that happens to have some impact on the securities markets. *See Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 38 (1977) (phrase "in connection with the purchase or sale of securities" is "limiting language"). To the contrary, a defendant's conduct "touches" or "coincides" with a securities transaction only if completion of the defendant's alleged fraudulent act *necessarily required or depended upon* a securities transaction. *See, e.g., O'Hagan*, 521 U.S. at 656 (defendant's fraud "consummated" by his securities trades; fraud would not have existed without the improper securities transactions – "in connection with" satisfied); *Zandford*, 535 U.S. at 820-21 (emphasizing that securities sales and defendant's fraudulent acts "were not independent events" because "each sale was made to further [his] fraudulent scheme," a scheme that "*coincided* with" and "*require[d]* the sale of securities" – "in connection with" satisfied) (emphasis added); *id.* at 820 (distinguishing hypothetical case where fraud would be complete – *either* – before *or* after – securities transaction occurred – "in connection with" not satisfied); *Bankers Life*, 404 U.S. at 8 (fraudulent scheme to purchase securities of corporation using that corporation's own assets *depended upon* sale of its securities – "in connection with" satisfied); *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 590-92 (2001) (plan not to allow exercise of stock option sold to plaintiff *necessarily required* sale of that option – "in connection with" satisfied).

An analysis of this Court's decisions applying the "in connection with" requirement shows that the requirement is satisfied only when a defendant's fraudulent activities require or depend upon a securities transaction. In each case, the "in connection with" requirement was satisfied

only if the defendant engaged in at least one of the following acts: (i) making a misrepresentation or false disclosure to *investors*; (ii) breaching a fiduciary duty owed to plaintiffs; and/or (iii) engaging in insider trading.

Case	Description	Misrepresentation to Investors?	Breach of Fiduciary Duty Owed to Plaintiffs?	Insider Trading?
Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 8 n.1 (1971)	Controlling stockholder misrepresented to investor that proceeds of a securities sale would be exchanged for certificate of deposit of equal value, thus breaching its fiduciary duty to corporation	✓	✓	
The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 596 (2001)	Corporation's promise to sell stock option while secretly intending not to permit its exercise constituted misrepresentation to investor	✓		

Case	Description	Misrepresentation to Investors?	Breach of Fiduciary Duty Owed to Plaintiffs?	Insider Trading?
S.E.C. v. Zandford, 535 U.S. 813, 823 (2002)	Broker breached fiduciary duty owed to his clients		✓	
Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972)	Market makers breached fiduciary duty owed to securities sellers		✓	
United States v. O'Hagan, 521 U.S. 642, 647 (1997)	Defendant bought call options based on material, non-public information			✓

The conduct alleged in each and every case in which this Court has found the "in connection with" requirement to be satisfied is conspicuously absent here. Petitioner here alleges merely that Respondents agreed to sell set-top boxes to Charter at inflated prices, to purchase advertising from Charter using the money it received from the inflated prices and to create new, backdated documents to reflect this agreement. Completion of these transactions by Respondents *in no way* required or depended upon any purchase or sale of Charter securities. In addition, as Petitioner concedes, Respondents made no misrepresentations to anyone, let alone to Charter shareholders. Respondents owed no fiduciary duty to Charter investors and did not trade in Charter securities. Consequently, Petitioner's allegations about Respondents do not involve either the type of conduct

or the relationship to the securities markets necessary to fulfill the "in connection with" requirement of Section 10(b). Respondents therefore cannot be liable for a violation of Rule 10b-5.[3]

C. A Defendant "Uses" Or "Employs" A Deceptive Device Only If It Directs A Specific And Affirmative Deceptive Act Toward Investors

This Court has not explicitly construed the terms "use" or "employ" in the context of a Section 10(b) claim. These words are straightforward and should be given their plain meaning. Both "use" and "employ" are active verbs. As such, they require some positive action. *See McGann v. Ernst & Young,* 102 F.3d 390, 394 (9th Cir. 1996) (holding that "the words 'use' and 'employ' require some positive action").[4] Congress' inclusion of this dynamic language demonstrates that Section 10(b) requires a defendant to engage in an affirmative act in order to be held liable. Moreover, the full text of the statute demonstrates that not any affirmative act will do. Instead, Section 10(b) requires a defendant to "use" or "employ" a "deceptive device" "in connection with the purchase or sale of securities."

In order to use or employ a deceptive device within the meaning of Section 10(b), a defendant must take an

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[3] The NAM takes no position as to the propriety of Respondents' conduct other than to state that the alleged conduct does not give rise to a private claim for damages under Section 10(b).

[4] "Use" and "employ" had very similar and inter-referential dictionary definitions when Section 10(b) was enacted. Webster's New International Dictionary (2d ed. 1934) defined "use" *inter alia* as "[t]o convert to one's service; to avail oneself of; to employ. . . ." and "[t]o put into operation; to cause to function. . . ." *Id.* at 2806. It defined "employ" *inter alia* as "to make use of, as an instrument, means or material; to apply; use. . . ." *Id.* at 839.

affirmative action and that action itself must deceive someone. Merely participating in *creating* a deceptive device does not satisfy the "use or employ" requirement. That requirement is only satisfied by a party that uses or employs the device to deceive investors. The act of creating or facilitating a deceptive device constitutes, at most, aiding and abetting another person's primary Section 10(b) violation. *See* Andrew S. Gold, *Reassessing the Scope of Conduct Prohibited by Section 10(b) and the Elements of Rule 10b-5: Reflections on Securities Fraud and Secondary Actors*, 53 Cath. U. L. Rev. 667, 680-83 (Spring 2004) ("Whatever degree of participation is demonstrated, if someone else's statements do the deceiving, the participant still cannot be said to 'use' the device to deceive.").[5]

Therefore, Charter's alleged reporting of inflated earnings to its investors based on its accounting for its transactions with Respondents constitutes a primary violation of Section 10(b). In order to deceive its investors, Charter allegedly conspired with Respondents to create inflated and backdated contracts. However, Respondents themselves are not alleged to have used or employed these

[5] Holding that Section 10(b)'s utilization of the term "use or employ" requires direct interaction with investors would be consistent with the manner in which this Court has interpreted those terms in construing other statutes. *See, e.g., Bailey v. United States*, 516 U.S. 137, 143 (1995) (federal statute imposing penalties for "use" of firearm during or in relation to drug trafficking offense required "*active employment*" of that firearm by defendant); *United States v. Cyprian*, 197 F.3d 736, 739 (5th Cir. 1999) (noting that various dictionary definitions of "use" suggest "action and implementation"); *Jones v. United States*, 529 U.S. 848, 855 (2000) (federal statute prohibiting destruction by fire or explosives of any building "used" in an activity affecting interstate or foreign commerce required more than a mere "passive, passing, or past connection to commerce").

backdated contracts to deceive anyone.[6] At most, Petitioner alleges that Respondents facilitated the creation of a deceptive device (*i.e.*, the contracts) that *Charter* thereafter used and employed to deceive investors.[7] Such conduct, if established, could amount to nothing more than aiding and abetting Charter's violation of Section 10(b), and thus could not give rise to primary liability in a private lawsuit brought under Section 10(b). *Central Bank*, 511 U.S. at 191. This distinction between primary and secondary violators is critical to manufacturers, who have no control over their purchasers' conduct, how their purchasers will account for transactions, how they will use documents associated with those transactions or whether or how they will make disclosures to their shareholders about any such transactions.

D. Petitioner Ignores Section 10(b)'s "Use Or Employ" And "In Connection With" Requirements, As Does Petitioner's Proposed "Purpose And Effect" Test

Petitioner pays scant attention to the "in connection with" and "use or employ" requirements. In quoting the statute, Petitioner conveniently omits any mention of the

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[6] Respondents are not even alleged to have created the purported scheme; Petitioner alleges that *Charter* devised the scheme and sought participants in it. *See* Pet. Br. at 5-6.

[7] Petitioner does not suggest that Respondents misled Charter in any way. This case is similar to most scheme liability cases, where plaintiffs typically allege that the third party vendor conspired with the issuer, rather than misleading it. *See, e.g., Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (2006); *see also Dutton v. D & K Healthcare Res.*, No. 4:04CV147SNL, 2006 WL 1778863 (E.D. Mo. June 23, 2006). Moreover, as discussed above, even an allegation that Respondents misled Charter would not be actionable under the securities laws because it would fail to satisfy the "in connection with" requirement.

"use or employ" or "in connection with" language, stating only that "Section 10(b) prohibits 'any . . . deceptive device or contrivance' by 'any person, directly or indirectly.'" Pet. Br. at 18. Petitioner limits its discussion of the "use or employ" requirement to one sentence in a footnote, suggesting only that "employ" is a synonym for "use" and that neither word requires any particular relationship between the defendant and those injured by the conduct. *Id.* at 20 n.6. Petitioner's treatment of the "in connection with" requirement is similarly negligible and conclusory. *Id.* at 22 (asserting with little explanation that "[t]he 'in connection with' language is more than satisfied here"). Petitioner's *amici* do not fare any better. With the exception of quoting the text of Section 10(b), none of them mention the "use or employ" or "in connection with" requirements at all.

Instead, Petitioner urges the Court to adopt a test that would hold third parties liable where "the purpose and effect of [their] conduct [was] to create a false appearance of material fact in furtherance of [a] scheme" to defraud the issuer's shareholders. Pet. Br. at 32. Petitioner's proposed test for scheme liability contradicts the clear language of Section 10(b) and the prior holdings of this Court.

First, the "purpose and effect" test ignores the "in connection with" and "use or employ" requirements entirely. Indeed, Petitioner's test would be met any time a common law fraud related in any way to securities. This approach directly contradicts this Court's warning that "the statute must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b). . . ." *Zandford*, 535 U.S. at 820; *see also Chiarella v. United States*, 445 U.S. 222, 232 (1980) ("[N]ot every instance of financial

unfairness constitutes fraudulent activity under § 10(b)."). Thus, Petitioner's reading of the statute unduly expands the scope of Section 10(b), despite the fact that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

In addition, Petitioner's "purpose and effect" test directly contradicts the Court's holding in *Central Bank*. Imposing liability on those whose conduct had "the purpose and effect of . . . creat[ing] a false appearance of material fact in furtherance of [a] scheme" would allow plaintiffs to evade *Central Bank*'s abolition of private actions for aiding and abetting liability. Before *Central Bank*, plaintiffs routinely labeled as "aiding and abetting" the kind of conduct that Petitioner now claims satisfies its "purpose and effect" test. *See, e.g., Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301 (10th Cir. 1987) (bank "aided and abetted in a conspiracy to promote the scheme by engaging in a fraudulent and deceptive transaction to create the false appearance to prospective investors" that a company would obtain loans from the bank).

Approval of Petitioner's "purpose and effect" test would revive aiding and abetting liability under a different name. Over the past few decades, this Court and the Congress have repeatedly attempted to curtail frivolous securities fraud litigation. Creative plaintiffs have attempted to circumvent these rulings, necessitating repeated clarifications from this Court. Petitioner is merely the latest in a long line of litigants that have sought to find ways around this Court's ruling in *Central Bank*. The NAM respectfully suggests that this Court not permit Petitioner to undermine the carefully developed jurisprudence in this area.

E. Section 10(b) Liability Requires A Breach Of A Duty To Plaintiffs

As the court below correctly stated, "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (citing *Santa Fe Indus. v. Green,* 430 U.S. 462, 474-75 (1977)). The Eighth Circuit's holding that duty (either created by speaking to investors or as a result of a fiduciary relationship) is a prerequisite to Section 10(b) liability provides a bright line rule that is consistent with this Court's precedent.

In *Affiliated Ute*, the Court considered the failure of market makers to disclose material information with respect to certain stock sales. The Court paid particular attention to the duty that the market makers owed the plaintiff under Rule 10b-5. Had the defendants acted merely as transfer agents, the Court explained, there would have been no duty to disclose. Instead, the defendants actively encouraged a market for the securities, and therefore were liable under Section 10(b) because of their "affirmative duty" to disclose information to investors. *Affiliated Ute*, 406 U.S. at 152.

The Court reaffirmed the importance of duty in *Chiarella*, where it held that an employee of a financial printer who bought stock after discovering the identity of the target in a corporate takeover bid could not be liable under Rule 10b-5(a) and (c) because he owed no disclosure duty to the shareholders of that target corporation. *Chiarella*, 445 U.S. at 228. As the Court held, omissions are actionable only where there is a duty to disclose based on a specific relationship between two parties. "The element required to make silence fraudulent – a duty to disclose – is absent in this case. No duty could arise from

petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them." *Id.* at 232.

The Court continued to emphasize duty in subsequent Section 10(b) cases. *See, e.g.*, *Dirks v. S.E.C.*, 463 U.S. 646, 666-67 (1983) (holding that, in absence of a breach of a fiduciary duty to shareholders by insiders who provided defendant with inside information, there was no derivative breach by the defendant and thus no liability); *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5."); *O'Hagan*, 521 U.S. at 662 (reiterating that Section 10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction") (quoting *Chiarella*, 445 U.S. at 230).

In sum, this Court has employed the bright line "duty" standard for Section 10(b) liability for the past several decades. This standard has provided manufacturers and vendors of products who engage in commercial transactions with public companies with a clear standard on which they could rely in shaping their conduct. Manufacturers and vendors understand that under existing precedent, because they owe no duty to the shareholders of those companies with which they do business, they have no obligation to make any disclosures to those shareholders. In the absence of any material statements made by a manufacturer to its purchasers' shareholders, a manufacturer has no possible civil liability under the securities laws to those shareholders. The "purpose and effect" test advocated by Petitioner diverges dramatically from these clear legal principles. The NAM respectfully suggests that the Court should reject this standard because it deviates from the statutory language and ignores decades of precedent.

II. PETITIONER'S PROPOSED "PURPOSE AND EFFECT" TEST IS CONTRARY TO SOUND PUBLIC POLICY

A. The Uncertainty Generated By Petitioner's "Purpose And Effect" Test Would Chill Legitimate Commerce And Harm The Economy As A Whole

As it has in the past, this Court should consider the policy implications of changing the scope of private civil liability under Section 10(b) and Rule 10b-5. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975) (explicitly basing decision to limit standing under Section 10(b) and Rule 10b-5 to purchasers and sellers partly on policy considerations); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510-11 (2006).

Such policy considerations include certainty and predictability, oft-recognized and laudable goals of statutory interpretation. *See, e.g., McBoyle v. United States*, 283 U.S. 25, 27 (1931) ("[F]air warning should be given to the world in language that the common world will understand, of what the law intends to do if a certain line is passed. To make the warning fair, so far as possible the line should be clear."); *Wilson v. Garcia*, 471 U.S. 261, 275 (1985) (stating that the Court's interpretation of a statute was supported by federal interests in uniformity, certainty and the minimization of unnecessary litigation).

Indeed, this Court relied on exactly such policy considerations in eliminating the private right of action for aiding and abetting liability. In *Central Bank*, this Court noted that "[t]he rules for obtaining aiding and abetting liability [were] unclear, in [securities litigation,] 'an area that demands certainty and predictability.'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). Lack of clarity "leads to the undesirable result of

decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business." *Id.* The Court concluded: "'[S]uch a shifting and highly fact oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5' is *not* a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions.'" *Id.* (quoting *Blue Chip Stamps*, 421 U.S. at 755) (emphasis added).

The Eighth Circuit's test, *supra* at 15, promotes certainty and predictability by informing companies that they can be held liable as primary Section 10(b) violators to the shareholders of another company only if they make a disclosure to those shareholders or otherwise owe them a duty. In contrast, under Petitioner's test, a company doing business with an issuer would be liable if the "purpose and effect" of the conduct at issue was found to create a false appearance of material fact in furtherance of a scheme to defraud the issuer's shareholders. That test provides neither certainty nor predictability. Were the Court to abandon decades of precedent and adopt Petitioner's proposed standard, a manufacturer would not know when an issuer's shareholder might allege that the issuer misrepresented details about a transaction with the manufacturer. Such a standard would offer manufacturers virtually no guidance, let alone certainty, regarding their potential liability.

Moreover, adoption of Petitioner's proposed standard would lead to an explosion of new scheme liability cases against manufacturers and other third parties. Despite the fact that this Court has never given any credence to Petitioner's scheme liability theory, there has been a recent proliferation of scheme liability cases, as creative plaintiffs have attempted to circumvent this Court's holding in *Central Bank*. The facts that plaintiffs consider

sufficient to give rise to securities fraud liability in these cases demonstrate the risks inherent in throwing open the floodgates of scheme liability by adopting Petitioner's proposed standard.

For example, vendors of goods and services have been sued under Rule 10b-5 "scheme" liability for (i) providing rebates on volume purchases of products because the purchaser allegedly failed adequately to describe the rebate program and its potential effect on the purchaser's business, *Amalgamated Bank v. Dell, Inc.*, Civ. Action No. 1:07-CA-00077-LY (W.D. Tex. Jan. 31, 2007); (ii) providing goods or services to a purchaser because the purchaser allegedly misrepresented the transaction and inflated its assets, *Dutton*, 2006 WL 1778863; and (iii) entering into commercial transactions because the other party allegedly recognized revenue improperly in connection with those transactions, *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003).[8] If this Court were to adopt Petitioner's amorphous "purpose and effect" test, the type of commercial entities that would be ensnared into the "scheme" web would be limited only by plaintiffs' counsel's imagination.[9]

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[8] Financial services firms also have faced scheme liability suits for setting up and/or financing transactions that an issuer allegedly misrepresented in its financial statements. *See, e.g.*, *In re Enron Corp.*, No. MDL-1446, Civ. Action No. H-01-3624, 2006 WL 4381143 (S.D. Tex. June 5, 2006); *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005); *Quaak v. Dexia*, 357 F. Supp. 2d 330 (D. Mass. 2005); *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804 (S.D. Tex. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003).

[9] Petitioner suggests that its proposed test will not create unfairness or uncertainty because companies either are "good" (and therefore not at risk of liability) or "bad" (and therefore not worthy of protection). *See* Pet. Br. at 32-34. The idea that "good" companies have nothing to worry about ignores practical reality. There is no reason to believe a plaintiff will know (or act upon) the "truth" about a defendant

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Although the alleged facts of these recent scheme cases vary slightly, they all have one thing in common. In each, the third party had no contact with the issuer's shareholders, and it was the issuer that made an alleged misrepresentation to its shareholders. As importantly, the third party lacked any control over how the issuer reported its dealings with the third party to its shareholders. By linking a third party's liability to the issuer's actions, Petitioner's test requires the third party to assume the risk that the primary violator will do something inappropriate over which the third party has no control.

The lack of certainty and predictability generated by the "purpose and effect" test would have a chilling effect on legitimate commerce and a negative effect on the economy as a whole. It would ask manufacturers to assume the costly and impossible role of watchdog over the conduct of their customers to ensure that they properly account for and disclose any transactions with that manufacturer. For example, in order to limit their Section 10(b) liability:

- Manufacturers would be forced to analyze their public customers' disclosures and financial statements to determine whether those customers correctly reported and accounted for transactions with the manufacturer;
- Manufacturers would be incentivized to do business with foreign or private companies rather than public U.S. companies to avoid risking securities fraud liability;

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ex ante and will only allege securities fraud against "bad" companies. Plaintiffs and their counsel are not triers of fact and cannot be counted on to serve a gatekeeper function.

- Manufacturers would hesitate to modify existing contracts at their customers' request for fear that the modifications, if undisclosed to their customers' auditors, would allow manipulation of their customers' financial results;
- Manufacturers would balk at including legitimate and competitively reasonable confidentiality provisions in their agreements, fearing plaintiffs would later claim those provisions reflect a scheme to conceal material information from the customers' investors;
- Manufacturers would think twice before advancing funds (*e.g.*, seller financing) or offering discounts to their customers out of concern that the customers would improperly account for the cash they received; and
- Manufacturers would be wary of doing business with public companies with high stock price volatility (*e.g.*, technology companies) because such companies could face greater potential securities fraud liability.

In sum, manufacturers would be forced to analyze business deals not only on their commercial merits but also on their potential for crushing securities fraud liability based on the conduct of a counterparty. That analysis would have to be done for each of the millions of sale transactions that take place annually. Adopting such a legal standard would harm manufacturers, their customers, the American consumer, and the U.S. economy as a whole.

Additionally, the significant litigation costs and possible broad liability imposed by the "purpose and effect" test would increase manufacturers' cost of production, causing them to pass these costs on to their customers. These price increases would undermine manufacturers'

competitiveness *vis-à-vis* foreign companies that do not face such costs or the risk of such massive liability. *See, e.g.*, Statement of J. Carter Beese, Jr., Chairman on behalf of the Capital Markets Regulatory Reform Project, Center for Strategic and International Studies before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, 1995 WL 83860 (March 2, 1995) ("[F]rom my vantage point on the [Securities Exchange] Commission, I became concerned that the costs of regulation, and the costs of litigation, were placing an unnecessary drag on the competitiveness of U.S. companies and U.S. capital markets, and imposing needless costs on consumers."). By imposing this burden on manufacturers, scheme theories such as the "purpose and effect" test ignore the practical realities of conducting business. Changing the scope of Section 10(b) in such a drastic manner is the sole province of Congress, not the courts.

B. Petitioner's "Purpose And Effect" Test Would Encourage Frivolous Claims, Increase Defendants' Cost Of Litigating And Encourage Coercive Settlements

If Petitioner's "purpose and effect" test were adopted, plaintiffs would be able to allege scheme liability – and survive Section 12(b)(6) motions to dismiss – with relative ease. The lower courts that have permitted scheme liability formulations similar to Petitioner's proposed standard have done just that, permitting claims against parties that did not speak to investors and owed them no duty. *See, e.g., In re Lernout & Hauspie*, 236 F. Supp. 2d at 177 (defendants, including investment fund and insurance company, owing no duty to issuer's shareholders, allegedly set up and funded outside sham entities that did business with issuer – motions to dismiss denied); *In re Parmalat*,

376 F. Supp. 2d at 517 (defendant bank, owing no duty to issuer's shareholders, allegedly structured loans to issuer and established invoice securitization program – motion to dismiss denied in part); *Quaak*, 357 F. Supp. 2d at 342 (defendant bank, owing no duty to issuer's shareholders, allegedly structured loans to issuer – motion to dismiss denied); *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 378 (5th Cir. 2007) ("*Enron*") (investment banks, owing no duty to issuer's shareholders, allegedly structured transactions with issuer – motions to dismiss denied).

Adopting Petitioner's standard would make it difficult for manufacturers, vendors and service providers who made no misrepresentations to plaintiffs, and who had no duty to them, to extricate themselves from frivolous lawsuits at an early stage.[10] Indeed, Petitioner's vague test would allow a plaintiff to survive a motion to dismiss just by uttering the talismanic phrases, "scheme to defraud" and "purpose and effect."

Petitioner's test is easy to allege and hard to refute on a motion to dismiss. Consider, as a hypothetical, that Supplier sells component parts for a finished product to Manufacturer (a public company) with the understanding that the parts can be returned by Manufacturer for any reason within 60 days. Supplier includes the right of return provision in a separate letter agreement, rather than the purchase order. Manufacturer records the purchase correctly in its financial statements. Supplier, however, incorrectly records excess revenue from the sale by claiming it is non-contingent and final and showing the

[10] In addition, more manufacturers will be sued if plaintiffs can ignore the limits of Section 10(b) (*e.g.*, the "in connection with" requirement) by alleging scheme liability.

purchase agreement, but not the side letter agreement, to its auditors. When the true nature of the transaction comes to light, Supplier's stock price falls and it files for bankruptcy. Supplier's shareholders then sue *Manufacturer* for securities fraud, alleging that Supplier and Manufacturer conspired to defraud them and that the "purpose and effect" of the separate side letter was to create a false appearance of material fact in order to further the scheme. In this example, Petitioner's "purpose and effect" test would sweep a third party actor into costly litigation merely because it engaged in a legitimate transaction with an issuer that may not have disclosed the transactions appropriately.

Additionally, the heavy cost of being mired in meritless, intractable litigation would encourage non-issuer defendants to enter into coercive settlements. *See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007) ("Private securities fraud actions . . . , if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law."); *Blue Chip Stamps*, 421 U.S. at 740 ("[E]ven a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.").

Moreover, secondary actors often must expend large amounts of money, even on pretrial matters. *See* 138 Cong. Rec. S12605 (Aug. 12, 1992) (remarks of Sen. Sanford) (asserting that in many securities fraud cases, major accounting firms pay eight dollars in legal fees for every one dollar paid in claims). The General Counsel of Sun Microsystems, for instance, testified before Congress as to

the effects of two frivolous securities fraud lawsuits that had been filed against Sun:

> [We] litigated these two matters vigorously, spending over $2.5 million on attorney fees and expenses in the period from June 1989 through January 1993; our directors and officers liability carrier spent approximately $2 million more. These figures do not include the public relations costs, many hours of senior management time diverted to the litigation, and the uncertainty generated by the situation. . . . [O]ur Board regarded it as a matter of fiduciary duty to explore settlement seriously, even though the idea of settling was deeply offensive to us. But the grim prospect of a jury trial, with all of its inherent unpredictability, forced us to consider any kind of "reasonable" settlement that might be achieved. Accordingly, [we] agreed to settle the first matter for $25 million, half of which was paid by the insurance carrier; and the second matter for $5 million, half of which also was paid by insurance. Of course, one-third of these settlements went to plaintiffs' counsel, not to any shareholder.

Testimony of Michael Morris, Vice President and General Counsel of Sun Microsystems before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, 1998 WL 96483 (F.D.C.H.) (Feb. 23, 1998). Scheme liability cases would serve to increase those litigation costs, and coerced settlements, unnecessarily.

The risk of coercive settlements is heightened for a third party that may have had limited involvement with an issuer but who potentially faces joint and several liability for all of the issuer's acts – acts over which it had no control. *See* 15 U.S.C. § 78u-4(f)(2)(A) (2007). Given the large market capitalizations of many companies in the United States and the correspondingly large declines in

value following the announcement of disappointing news, adoption of Petitioner's proposed standard would create the prospect that numerous manufacturers and other third parties would face *billions* of dollars in potential joint and several liability simply because they have done business with a company that is accused of securities fraud. The *in terrorem* effect of joint and several liability further underscores the likely chilling effect of broad scheme liability on domestic commerce.

This Court has long understood that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. Over the years, both Congress and this Court have taken steps to mitigate this danger. In *Blue Chip Stamps*, for example, the Court limited standing in private Rule 10b-5 actions to purchasers and sellers of securities, citing the need for a bright-line rule. *See id.* at 742. In *Central Bank*, the Court dispensed with aiding and abetting liability in private actions partly because it "exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets." *Central Bank*, 511 U.S. at 188. More recently, in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005), the Court determined that plaintiffs must make a meaningful showing of actual loss causation in order to maintain a private right of action under Section 10(b). Then, only a few weeks ago, the Court again raised the bar for plaintiffs by elevating the scienter pleading standards in many circuit courts. *Tellabs, Inc.*, 127 S. Ct. at 2504-05.

Indeed, the *Central Bank* Court acknowledged the very same kinds of costs that the NAM has pointed out here. "[U]ncertainty and excessive litigation can have ripple effects. . . . [N]ewer and smaller companies may find it difficult to obtain advice from professionals. A professional

may fear that a newer or smaller company may not survive and that business failure would generate securities litigation *against the professional*, among others. In addition, the increased costs incurred by professionals because of the *litigation and settlement costs under 10b-5 may be passed on* to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute." 511 U.S. at 189 (emphasis added). Similarly, the uncertainties associated with Petitioner's scheme theory reduce the willingness of companies to do business with one another, and the massive litigation and settlement costs generated by Petitioner's theory ultimately get passed to consumers.

For its part, Congress enacted the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), Pub. L. 104-69, 109 Stat. 737 (Dec. 22, 1995) to curb these costs and abuses, including "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent'. . . ." *Dabit*, 126 S. Ct. at 1510-11 (quoting H.R. Rep. No. 104-369, p. 31 (1995)). In addition to imposing stringent pleading requirements, *see* 15 U.S.C. § 78u-4(b) (2007), the PSLRA reflected Congress' tacit approval of *Central Bank*'s bar on private aiding and abetting liability. *Cf.* 15 U.S.C. § 78t(e) (2007) (allowing SEC enforcement against aiders and abettors but not creating a private right of action). Moreover, when it became apparent that plaintiffs were attempting to avoid the PSLRA's strictures by bringing securities fraud class actions in *state* court, Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. 105-353, 112 Stat. 3227 (Nov. 3, 1998). *See Dabit*, 126 S. Ct. at 1511 (broadly construing SLUSA's pre-emption provisions to better effect the PSLRA's goals).

To permit scheme liability would not only allow Petitioner to circumvent *Central Bank*'s clear prohibition on private aiding and abetting liability, but also would undermine more than 30 years of carefully-crafted judicial and congressional efforts to cabin frivolous securities fraud litigation.

C. Section 10(b) Jurisprudence Should Not Be Premised Upon A Search For Deep Pockets

Petitioner's *amici* suggest that, because issuers that engage in wrongdoing often are insolvent, outside actors are the only potential defendants "with assets sufficient to satisfy a judgment or fund a settlement. . . ." *See, e.g.*, AARP Br. at 3. According to these *amici*, investors require scheme liability to obtain adequate compensation. This argument rests upon the explicit premise that, whatever countervailing policy considerations might exist, "[n]one of them is more important . . . than the ability of defrauded investors to recover their losses. . . ." *Id.* at 12. That premise should be rejected.

Defrauded investors deserve redress, but their remedies should not come at the expense of those who did not violate the securities laws. Fairness – not a blind quest for compensation – is the most important consideration, and it is fundamentally unfair to craft Section 10(b) jurisprudence around an indiscriminate search for deep pockets. *See Dura Pharmaceuticals*, 544 U.S. at 345 (stating that it is *not* the goal of the securities laws "to provide investors with broad insurance against market losses"). It also is fundamentally unfair to impose massive defense costs and liability on third parties simply because they did business with a primary violator. Guilt by association is not a reasonable or fair way to define the scope of Section 10(b).

Indeed, if the Court adopts Petitioner's proposed "purpose and effect" test, it would permit issuers and their officers and directors (*i.e.*, those alleged to have actually made misleading statements to shareholders) to seek contribution from manufacturers and other companies that did business with them. Were this to occur, securities litigations would become even more complex and expensive than they already are. Moreover, such third party practice would tend to shift liability from the parties who ordinarily are most central to any alleged fraud to those with only a tangential relationship to the alleged fraud simply because they have deeper pockets. Revising the scope of Section 10(b) to compensate investors from the coffers of any company that may have aided and abetted a primary violation, as Petitioner and its *amici* advocate, requires an act of Congress, not an expansion of an implied right of action by the courts. *See In re Charter Commc'ns, Inc. Sec. Litig.*, 443 F.3d at 993 (a "decision[] of this magnitude should be made by Congress[,]" if at all).

IV. CONCLUSION

For the reasons stated above, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE NEW YORK STATE TEACHERS' RETIREMENT SYSTEM, THE RETIREMENT SYSTEMS OF ALABAMA, THE SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM, AND THE GOVERNMENT OF GUAM RETIREMENT FUND AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF AMICI CURIAE[1]

This brief is filed by public pension systems who purchase publicly traded securities on behalf of their beneficiaries and, therefore, have a strong interest in the proper interpretation of the securities laws. These investors believe that Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5 should be interpreted in accordance with their plain language and to achieve Congress's intent to permit investors to recoup their losses caused by deceptive conduct in connection with purchases and sales of securities from the perpetrators of the deceptive conduct, deter future frauds, and maintain fair, honest, and efficient capital markets.

Each year, *amici* invest billions of dollars in U.S. capital markets on behalf of hundreds of thousands of beneficiaries. The New York State Teachers' Retirement System ("NYSTRS") has over $100 billion in assets as of March 31, 2007, of which over $67 billion is invested in domestic fixed income and equity securities. NYSTRS is one of the ten largest public retirement systems in the United States and provides retirement benefits for approximately 264,000 active and 130,000 retired New York State public school teachers and administrators. The Retirement Systems of Alabama ("RSA") manages 20 funds with aggregate assets of over $30 billion as of September 30, 2006 for the benefit

1. This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici* and their counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of this brief, and copies of their consents are being filed herewith.

of approximately 213,000 active and 95,000 retired public school teachers, State judges, and other employees of the State of Alabama. Approximately 48% of RSA's assets is invested in domestic common and preferred stocks, and approximately 20% in domestic bonds. The Sacramento County Employees' Retirement System ("SCERS") has $5.8 billion in assets as of March 31, 2007, of which over $2.0 billion is invested in domestic equity securities and $1.3 billion in fixed income securities. SCERS provides retirement benefits for more than 14,000 active and 5,000 retired employees of Sacramento County, California. The Government of Guam Retirement Fund is a $3.94 billion pension plan for employees of the Government of Guam.

In the aggregate, state and local government pension plans such as these cover more than 14 million workers and 6 million retirees and other beneficiaries and have assets of more than $2 trillion.[2] In 2005, investment earnings accounted for 74 percent of all public pension plan revenue and employer (*i.e.*, taxpayer) contributions for only 17 percent.[3]

The *amici*'s overriding responsibility is to invest for the retirement and long-term security of their hundreds of thousands of beneficiaries. As major investors with long-term outlooks, the *amici* are vitally concerned with the proper and efficient functioning of U.S. capital markets, and are particularly concerned that investors not be harmed by illegal

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2. *See* Gary W. Anderson & Keith Brainard, "Profitable Prudence: The Case for Public Employer Defined Benefit Pension Plans," Pension Research Council Working Paper 2004-6, The Wharton School, University of Pennsylvania, *available at www.nasra.org/resources/dbdcissues.htm* (last visited on June 1, 2007).

3. *See* National Association of State Retirement Administrators, "Key Facts Regarding State and Local Government Defined Benefit Retirement Plans," *available at* www.nasra.org/news/article.asp?newsid=112 (last visited on June 1, 2007).

conduct affecting the market for publicly traded securities. Many state and local governments are constitutionally obligated to guarantee defined benefit retirement plans. Therefore, investment losses due to securities fraud fall directly on state and local governments and ultimately on taxpayers. If public pension funds are prevented from recovering money lost to securities fraud, the public will suffer.

The recent scandals at companies such as Enron, WorldCom, Global Crossing, Tyco, and McKesson-HBOC have unfortunately shown that even large, well-known companies and their business partners are not immune to the development of a culture of greed which encourages short-sighted and ultimately wrongful business practices and eventually results in billions, if not trillions of dollars in losses to innocent investors. As investors who have been materially harmed by corporate fraud, *amici* are vitally concerned that the law allow injured investors to recover from perpetrators of fraud.

The *amici* strongly believe that investors' ability to redress corporate wrongdoing through class and individual actions under the securities laws is essential to deter improper conduct and to recoup losses caused by fraud. Indeed, in passing the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 ("PSLRA"), Congress sought "to increase the likelihood that institutional investors will serve as lead plaintiffs," based on its belief "that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Conf. Rep. 104-369, 1995 U.S.C.C.A.N. 730, 732.[4] Following the

4. The *amici*, as long-term investors, also have a strong interest in preventing meritless, lawyer-driven litigation. As one of many ways the PSLRA discourages meritless cases, the statute's (Cont'd)

passage of the PSLRA, the *amici* have served as lead plaintiffs in cases resulting in substantial recoveries, including *In re HealthSouth Corp. Bondholder Litigation*, No. 03-CV-1500 (N.D. Ala.), in which Retirement Systems of Alabama is the court-appointed lead plaintiff and has achieved partial settlements totaling approximately $445 million from HealthSouth and other defendants. Retirement Systems of Alabama is continuing to prosecute claims against certain defendants, including "scheme liability" claims under Rule 10b-5(a) and (c) against HealthSouth's auditor and underwriters for their allegedly knowing, deceptive conduct in furtherance of the scheme to defraud HealthSouth investors.

SUMMARY OF ARGUMENT

When a defendant knowingly engages in conduct that has the principal purpose and effect of creating a false appearance of fact about a public corporation's business and financial results in furtherance of a scheme to defraud the corporation's investors, the defendant's acts fall squarely within the express scope of Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c). *See Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), *petition for certiorari filed sub nom. Avis Budget Group, Inc. v.*

(Cont'd)

"professional plaintiff" provision bars a plaintiff from serving as lead plaintiff in more than five actions filed within three years, except as permitted by the court. *See* 15 U.S.C. § 78u-4(a)(3)(B)(vi). Notably, Congress gave courts discretion to allow "[i]nstitutional investors seeking to serve as lead plaintiff. . . to exceed this limitation [because they] do not represent the type of professional plaintiff this legislation seeks to restrict." H.R. Conf. Rep. 104-369, 1995 U.S.C.C.A.N. 730, 734.

California State Teachers' Retirement System, No. 06-560 (U.S. Oct. 19, 2006). Regardless of whether such a defendant made a public statement concerning the deceptive transaction, the defendant has engaged in deceptive conduct constituting a primary violation of Section 10(b), which makes it unlawful for "any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of [Rule 10b-5]." 15 U.S.C. § 78j(b). Rule 10b-5, which is coextensive with Section 10(b), imposes primary liability on persons who "directly or indirectly . . . employ any device, scheme or artifice to defraud" or "engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security." 17 C.F.R. § 240.10b-5(a) and (c). To find otherwise – to immunize parties who enter into sham transactions that have the principal purpose and effect of artificially distorting a public company's financial statements – would be to rewrite and unduly narrow both the statute and rule.

This Court's precedents, including *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), support liability for such persons. *Central Bank* states that "any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191 (emphasis in original). *Central Bank*'s holding "that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)" did not eliminate primary liability for violations of Rule 10b-5(a) and (c) and could not do so without ignoring the plain

language of the statute and reading subsections (a) and (c) out of the rule. Post-*Central Bank* decisions of this Court confirm that, in addition to making a material misstatement, using a manipulative or deceptive device can give rise to liability under Section 10(b) and Rule 10b-5. *See, e.g.*, *SEC v. Zandford*, 535 U.S. 813, 815 (2002) ("Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' that conduct, without more, was a fraud.").

Construing Section 10(b) and Rule 10b-5 in accordance with their plain language does not threaten to impose liability for securities fraud on those who participate in legitimate commercial transactions with public corporations. A legitimate transaction becomes neither a "device, scheme or artifice to defraud" under Rule 10b-5(a) nor an "act, practice, or course of business which operates or would operate as a fraud or deceit" under Rule 10b-5(c) simply because a public corporation involved in the transaction chooses to misrepresent that transaction in its financial statements. A commercial counterparty is subject to scheme liability under Rule 10b-5(a) and (c) only if the commercial counterparty itself engages in deceptive conduct – *i.e.*, if the principal purpose and effect of the counterparty's own conduct is to artificially distort the public corporation's financial statements or otherwise create a false appearance about its business. A commercial counterparty that enters into an inherently legitimate loan or other transaction with a securities issuer does not engage in deceptive conduct, even if the counterparty knows that the issuer plans to make false statements about the transaction, so long as the principal purpose and effect of the counterparty's action is not to distort the public company's financial statements. In that circumstance, the counterparty is at most an aider and abettor

and, as such, is not subject to liability for securities fraud. *See Simpson v. AOL Time Warner Inc.*, 452 F.3d at 1050.

The stringent pleading standards for allegations of fraud under Rule 10b-5 further protect legitimate commercial counterparties. In particular, plaintiffs must adequately allege that the commercial counterparty acted with scienter under the demanding pleading standard of the PSLRA.

ARGUMENT

I. THE PLAIN LANGUAGE OF SECTION 10(b) AND RULE 10b-5 IMPOSES LIABILITY ON PERSONS WHO ENGAGE IN MANIPULATIVE OR DECEPTIVE DEVICES OR ACTS

"With respect . . . to the first issue, the scope of conduct prohibited by § 10(b), the text of the statute controls [the Court's] decision." *Central Bank*, 511 U.S. at 173. This Court's "cases considering the scope of conduct prohibited by § 10(b) in private suits have emphasized adherence to the statutory language, '[t]he starting point in every case involving construction of a statute.'" *Id.* (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); alteration in *Central Bank*). Section 10(b) of the Exchange Act explicitly delegates authority to the SEC to prescribe rules, "as necessary or appropriate in the public interest or for the protection of investors," making it "unlawful for any person, directly or indirectly," to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b). The SEC has implemented Section 10(b) by adopting Rule 10b-5, which is "coextensive with the coverage of § 10(b)." *SEC v. Zandford*, 535 U.S. at 816 n.1 (citing *United States v. O'Hagan*, 521 U.S. 642, 651 (1997), and *Ernst & Ernst v.*

Hochfelder, 425 U.S. at 214); *see also Central Bank*, 511 U.S. at 172 ("Rule 10b-5 . . . casts the prohibition in similar terms" to Section 10(b)).

Rule 10b-5(a) makes it unlawful for "any person," "directly or indirectly," to "employ any device, scheme, or artifice to defraud." This Court has held that "any manipulative or deceptive device or contrivance" in Section 10(b) includes a "project," "scheme" (including "a scheme to deceive"), "stratagem," "artifice," and "plan," *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 n.20 (citing definitions of "device" and "contrivance" from WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)), and that Section 10(b) applies to "complex securities frauds" in which "there are likely to be multiple violators," *Central Bank*, 511 U.S. at 191. Rule 10b-5(c) makes it unlawful for "any person," "directly or indirectly," to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . ."

The prohibitions of Section 10(b) and Rule 10b-5(a) and (c) apply to conduct beyond the making of false statements and misleading omissions, which are prohibited by Rule 10b-5(b). As this Court has held, Section 10(b) also applies to deceptive "practices," *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-76 (1977), deceptive "conduct," *id.* at 475 n.15; *O'Hagan*, 521 U.S. at 659, and deceptive "acts," *Central Bank*, 511 U.S. at 173. "To be sure, the second subparagraph of the rule [i.e., Rule 10b-5(b)] specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs [i.e., Rule 10b-5(a) and (c)] are not so restricted." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972). Indeed, Rule 10b-5 forbids "any course

of conduct that has the effect of defrauding investors." *Ernst & Ernst v. Hochfelder*, 425 U.S. at 212. Section 10(b) and Rule10b-5's "proscriptions, by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive." *Affiliated Ute Citizens*, 406 U.S. at 151.

Were the Court to hold that a person who engages directly or indirectly in conduct which has the primary purpose and effect of creating a false appearance about an issuer's business and financial results is not a primary violator of Section 10(b) and Rule 10b-5, the Court would effectively be eliminating the express language "directly or indirectly . . . to use or employ . . . any manipulative or deceptive device or contrivance" from the statute, as well as reading subsections (a) and (c) out of the rule. As the Court has often held, a statute should not be construed in a way that renders some of its provisions superfluous. *See, e.g., TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001); *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994).

Zandford demonstrates that Rule 10b-5(a) and (c) are indeed not superfluous. In that case, the Court held that a broker's course of conduct in selling his customers' securities in order to misappropriate the proceeds, without making any misrepresentations actionable under Rule 10b-5(b), constituted a fraudulent scheme under Rule 10b-5(a) and a course of business that operated as a fraud under Rule 10b-5(c): "Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' that *conduct*, '*without more*,' was a fraud." 535 U.S. at 815 (emphasis added).[5] Similarly, a party who engages in

5. Respondents may seek to distinguish *Zandford* by arguing that the broker's liability in that case depended on his omission to (Cont'd)

inherently deceptive transactions with a securities issuer – transactions whose principal purpose and effect is to create a false appearance about the issuer's business and financial results – engages in deceptive conduct that is designed to and has the effect of defrauding investors. Such inherently deceptive conduct by a "secondary" actor gives rise to primary liability under Rule 10b-5(a) and (c). It differs from aiding and abetting that does not itself involve deceptive conduct by the secondary actor, such as making a legitimate loan that the lender knows or believes the issuer intends to account for improperly as equity. By contrast, aiding and abetting a fraud by entering into a loan or other intrinsically legitimate transaction should not be actionable under any

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state material facts when he had a duty to disclose the truth to his clients. *See, e.g.*, Taavi Annus, *Scheme Liability Under § 10(b) of the Securities Exchange Act of 1934*, 72 Mo. L. Rev. No. 3 (forthcoming), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=980025*, at *26 ("supporters of the restrictive view [of scheme liability] . . . claim that the theory used in *Zandford* was based on a violation of a duty to disclose (i.e. omission) on the part of the broker who had fiduciary duties towards his client"). However, the Court's opinion in *Zandford* describes "conduct, 'without more,'" not "omissions," as constituting the fraud, 535 U.S. at 821, and cases finding liability for deceptive conduct in the absence of any disclosure are sometimes, like *Zandford*, based on Rule 10b-5(a) and (c), not Rule 10b-5(b), because Rule 10b-5(b) prohibits omissions only when there is a duty to correct previous statements. *See Chiarella v. United States*, 445 U.S. 222, 225 n.5 (1980); *United States v. Bongiorno*, No. 05 Cr. 390(SHS), 2006 WL 1140862, at *7-9 (S.D.N.Y. May 1, 2006). Thus, *Zandford*'s holding that conduct without more constituted fraud did not depend on whether the broker had a duty to disclose the truth to his clients. *See also In re Mutual Funds Investment Litig.*, 384 F. Supp. 2d 845, 855-62 (D. Md. 2005) (holding that brokerage firms and investment funds that created and profited from scheme to engage in late trading of mutual fund shares could be held liable under Rule 10b-5 (a) and (c)).

section of Rule 10b-5, even if the party entering into the loan or other intrinsically non-deceptive transaction knows or has reason to know that the issuer intends to make false statements about the transaction.

This Court has consistently held that Section 10(b) should be construed "'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Zandford*, 535 U.S. at 819 (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)). One of Congress's principal stated purposes in enacting the Exchange Act, including Section 10(b), was "to insure the maintenance of fair and honest markets in [securities] transactions." 15 U.S.C. § 78b. Under this Court's flexible construction of their broad and inclusive terms in light of that purpose, Section 10(b) and Rule 10b-5 "prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971).

The standard advocated by *amici* in this brief is consistent with the standard adopted by the Ninth Circuit in *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), in which the court accepted the SEC's argument that "[a]ny person can be primarily liable under Section 10(b) and Rule 10b-5(a) for engaging in a scheme to defraud, so long as he himself, directly or indirectly, engages in a manipulative or deceptive act as part of the scheme." *Simpson v. Homestore.com, Inc.*, No. 04-55665, Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions That Favor Appellant, at *16 (9th Cir. Oct. 22, 2004), *available at* www.sec.gov/litigation/briefs/homestore_102104.pdf. In that case, the SEC urged the

following test for determining when a party's conduct as part of a scheme to defraud constitutes a primary violation:

> Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10b-5 and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

Id. (emphasis added). *See also Simpson v. Homestore.com, Inc.*, No. 04-55665, Reply Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions That Favor Appellant (9th Cir. Feb. 4, 2005), *available at* www.sec.gov/litigation/briefs/homestore_020405.pdf.[6]

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6. The *amici*, of course, advocate a "no" answer to the question presented as stated in the Court's Order granting certiorari in this case:

> Whether this Court's decision in *Central Bank* . . . *forecloses* claims for deceptive conduct under § 10(b) . . . and Rule 10b-5(a) and (c) . . . where [defendants] engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where [defendants] themselves made no public statements concerning those transactions.

Order, No. 06-43 (U.S. Mar. 26, 2007) (emphasis added). However, *amici* respectfully urge that, when answering the question presented in the negative, the Court also make clear that conduct having no legitimate business or economic purpose will not be saved from liability through the addition of some insubstantial business purpose

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To establish a defendant's liability under Section 10(b) and Rule 10b-5, the plaintiff must prove not only (1) that the defendant used or employed a manipulative or deceptive device or contrivance, (2) with scienter, but also (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation. *See Dura Pharmas., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). Economic loss and loss causation in scheme liability cases generally present no different problems than in misrepresentation cases under Rule 10b-5(b). The reliance and "in connection with" elements of claims under Rule 10b-5 call for brief comment in relation to scheme liability.

A plaintiff may be presumed to have relied on a misrepresentation if the misleading or false information was injected into an efficient market. *See Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988). The fraud-on-the-market presumption requires the dissemination of the misrepresentation into an efficient market, but not personal involvement by each defendant in disseminating the information. *See AOL Time Warner*, 452 F.3d at 1051; *see also* 4 Alan R. Bromberg & Lewis D. Lowenfels, BROMBERG & LOWENFELS ON SECURITIES FRAUD § 7:469 (2d ed. 2006) (fraud-on-the-market presumption "applies to all

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proffered by crafty perpetrators of fraud as a purported cover for their predominantly deceptive conduct in furtherance of the scheme. In accordance with this Court's teaching that Section 10(b) prohibits not only "garden type variet[ies] of fraud," but also "unique form[s] of deception" and "[n]ovel or atypical methods" of committing securities fraud, *Bankers Life*, 404 U.S. at 11 n.7, the standard for scheme liability should look to whether each defendant engaged in conduct that had the principal purpose and effect of creating an artificial appearance of fact about a transaction involving the issuer.

three clauses of Rule 10b-5: (1) scheme to defraud, (2) misrepresentation or omission, and (3) fraudulent course of business"). The Eighth Circuit in this case erroneously held that plaintiffs could not establish reliance because respondents did not make any misstatements to the investing public about Charter. *See In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006). The court below thus ignored this Court's holding that there need not be a misrepresentation for a defendant to "run afoul of the [Exchange] Act." *Zandford*, 535 U.S. at 820. The Eighth Circuit also failed to recognize that a "device, scheme, or artifice to defraud" or "act, practice, or course of business which operates or would operate as a fraud or deceit on any person" is complete only upon the dissemination to investors of the false appearances created by the scheme or course of business. Thus, reliance in scheme liability cases may be established under the fraud-on-the-market theory.

Similarly, a scheme to misrepresent the financial results or other facts about a company coincides with the purchase or sale of the company's securities because the scheme is incomplete until the fraudulent information generated by the conduct of the participants in the scheme is disclosed to investors. *See AOL Time Warner*, 452 F.3d at 1051. There is no requirement that every participant in the scheme release the information to the public for all defendants in the scheme to have caused the dissemination of false information to the market. *See Central Bank*, 511 U.S. at 191 ("In any complex securities fraud . . . there are likely to be multiple violators."). Indeed, the Eighth Circuit in this case did not deny that plaintiffs adequately pled that defendants' conduct was in connection with purchases or sales of Charter securities. Thus, properly pled scheme liability claims under Rule 10b-5 can satisfy every element of a valid claim.

Private securities litigation is "a most effective weapon" in enforcing the securities laws, serving as a necessary supplement to SEC enforcement actions. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985). Congress, in adopting the PSLRA, reaffirmed that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses" and that private lawsuits "promote public and global confidence in our capital markets and help to deter wrongdoing and guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995). Investors who are defrauded by sophisticated deceptive schemes such as the sham, round-trip advertising transactions alleged in this case should be permitted to sue all the parties that engaged in deceptive conduct.

II. THE COURT BELOW MISINTERPRETED *CENTRAL BANK*

In this case, as it did in *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 521 U.S 642 (1997), the Eighth Circuit interpreted *Central Bank* far too broadly. Here, the Eighth Circuit construed *Central Bank* to mean that a "device or contrivance is not 'deceptive' within the meaning of § 10(b) absent some misstatement or a failure to disclose by one who has a duty to disclose. . . ." 443 F.3d at 992. This sweeping interpretation of *Central Bank* cannot be squared with either the Court's actual holding in *Central Bank* or the text of Section 10(b) and Rule 10b-5.

In *Central Bank*, this Court addressed a fairly limited question: "whether private civil liability under § 10(b) extends . . . to those *who do not engage* in the manipulative or deceptive practice, but who aid and abet the violation."

511 U.S. at 167 (emphasis added). The plaintiffs in *Central Bank* conceded that the defendant was only an aider and abettor, not a primary violator. *See id.* at 191. Thus, contrary to the Eighth Circuit's overbroad misinterpretation, *Central Bank* did not address whether a device is "deceptive" absent a misstatement or duty to disclose – which is a question regarding the scope of *primary liability* under the statute and rule. Rather, the Court "reach[ed] the uncontroversial conclusion . . . that the text of the 1934 Act does not reach those who aid and abet a § 10(b) violation [and held] that conclusion resolves the case." 511 U.S. at 177.

Moreover, other statements in *Central Bank* demonstrate that the Court did not intend to narrowly proscribe Section 10(b) and Rule 10b-5 such that a "deceptive" device would always require an affirmative misstatement or a violation of a duty to disclose (a reading that is inconsistent with the plain text of the statute and the rule). For instance, after noting that "the text of the statute controls our decision," the Court described the statute as prohibiting all "manipulative or deceptive *acts* in connection with the purchase or sale of securities," *id.* at 173 (emphasis added), a prohibition that encompasses far more than making a material misstatement, refusing to speak when one has a duty to disclose, or engaging in market manipulation. The Court also noted, when explaining why Section 10(b)'s "'directly or indirectly' language" does not justify imposing liability on one who merely aids or abets the violation of another, that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* at 176. Thus, *Central Bank* does nothing more than reach the "uncontroversial conclusion" that Section 10(b)

and Rule 10b-5 liability do not attach to actors, including aiders and abettors, unless they *engage, directly or indirectly, in conduct proscribed by the statute and rule.*

The Court's statement in *Central Bank* about the potential primary liability of "secondary actors," including lawyers, accountants, and banks, discussed above, cannot be squared with the Eighth Circuit's constricted reading of that case. *See* 511 U.S. at 191. The mere fact that a party who committed a *primary violation* could *also*, by virtue of the same conduct, be said to have "aided and abetted" another's violation, does not shield the wrongdoer from liability for their own unlawful primary violation. The key question with respect to primary liability remains: Did the secondary actor, who may have aided and abetted another's unlawful conduct, also directly or indirectly engage in the conduct prohibited by Section 10(b) and Rule 10b-5? If yes, the secondary actor can be held liable as a primary violator in a private action.

This unsurprising conclusion finds support in the Court's citation to Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 69 CAL. L. REV. 80, 107-08 (1981), in *Central Bank*. *See* 511 U.S. at 191. On the specific pages cited by the Court, Professor Fischel stated:

> Deceptive conduct by attorneys and accountants, whether previously analyzed as aiding and abetting or as a direct violation, should continue to be prohibited by the section and the rule, provided the other elements of liability . . . are satisfied.

Id. at 108. Exactly the same conclusion should apply to business counterparties who, like Respondents in this case,

allegedly engaged in "deceptive conduct" that acted as a fraud on purchasers and sellers of Charter Communications stock.

Thus, *Central Bank* establishes three points: (1) the Court in that case was concerned only with deciding whether liability could be imposed on one who did not directly or indirectly engage in the prohibited, deceptive conduct, but simply aided or abetted another party's violation; (2) read as a whole, *Central Bank* establishes that any manipulative or deceptive act in connection with a purchase or sale of securities violates Section 10(b), but that decision does not narrowly confine the acts that fall within the statute's prohibition to require an affirmative misstatement or violation of a duty to disclose; and (3) conduct by a secondary actor that can be characterized as aiding and abetting can also constitute a primary violation of the statute if the secondary actor directly or indirectly uses or employs, in connection with the purchase or sale of any security, any of the deceptive devices and contrivances prohibited by Rule 10b-5.

It was appropriate for the Court in *Central Bank* not to attempt to specifically delineate the distinction between aiding and abetting, on the one hand, and primary liability of secondary actors, on the other. Drawing that distinction would have required the Court to address issues that were not presented by *Central Bank*'s facts. *Central Bank* appropriately left the scope of primary liability of secondary actors to be decided on the basis of pertinent facts.

Moreover, before *Central Bank*, the distinction between aiding and abetting and secondary actors' primary liability did not receive much attention, because a party who aided and abetted a violation of Section 10(b) and Rule 10b-5 could be held liable without regard to whether the defendant also

directly or indirectly engaged in a manipulative or deceptive act or practice. As Professor Fischel observed, "under a strict aiding and abetting analysis, it is irrelevant whether an aider and abettor has engaged in a manipulative or deceptive practice within the meaning of section 10(b)." 69 CAL. L. REV. at 88; *see also In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 495-98 (S.D.N.Y. 2005) (Kaplan, J.). Thus, this Court and the lower courts in earlier, pre-*Central Bank* cases had little occasion to define when secondary actors are primarily liable.

This Court's statements interpreting Section 10(b) and Rule 10b-5 in decisions handed down after *Central Bank*, on the other hand, have particular relevance to the issue in this case, because when it made them, the Court did so knowing both that liability could not be imposed for aiding and abetting and that the outer limits of what constitutes a primary violation of the statute and the rule had yet to be defined. The Court, in all three of its decisions interpreting Section 10(b) and Rule 10b-5 handed down after *Central Bank*, has defined more broadly than did the court below the range of conduct that violates the statute and rule.

In *United States v. O'Hagan*, 521 U.S. 642 (1997), the issues under Section 10(b) and Rule 10b-5 were whether O'Hagan, who had misappropriated material information from his law firm employer and that firm's client, (a) had used a deceptive device and (b) had done so in connection with the purchase and sale of securities. The Court in reversing the Eighth Circuit's decision found that O'Hagan's trading on the basis of misappropriated information, without disclosing that he was doing so, involved the use of a deceptive device, even though O'Hagan did not make any material misstatements and did not owe any duty to speak to the persons with whom he traded. The Court quoted Rule

10b-5(a) and (c) and acknowledged that "[l]iability under Rule 10b-5 . . . does not extend beyond § 10(b)'s prohibition." *Id.* at 651. But the Court also pointed out: "The provision, as written, does not confine its coverage to deception of a purchaser or seller of securities; rather, the statute reaches any deceptive device used 'in connection with the purchase or sale of any security.'" *Id.* (citation omitted).

The Court also observed:

> The misappropriation theory comports with § 10(b)'s language, which requires deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller. The theory is also well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.

Id. at 658 (emphasis added). Finally, the Court faulted the Eighth Circuit for reading too narrowly the statement in *Central Bank* concerning secondary actors' potential liability. It explained that "this Court, in the quoted passage, *sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under § 10(b) and Rule 10b-5 for certain conduct.*" *Id.* at 664 (emphasis added).[7]

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7. Similarly, the Court's statement in *Central Bank* that "As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," 511 U.S. at 177, was not a definitive description of the outer limits of the conduct proscribed by § 10(b) and Rule 10b-5, nor was it

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In *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001), a unanimous Court again reaffirmed that Section 10(b) and Rule 10b-5 prohibit a broad range of manipulative and deceptive acts and practices, not simply misrepresentations, omissions, and market manipulation. First, the Court described Rule 10b-5 as follows:

> That Rule forbids the use, 'in connection with the purchase or sale of any security,' of (1) '*any device, scheme or artifice to defraud*'; (2) 'any untrue statement of a material fact'; (3) the omission of 'a material fact necessary in order to make the statements made not misleading'; or (4) *any other 'act, practice or course of business' that 'operates . . . as a fraud or deceit.'*

Id. at 593 (emphasis added). Then, the Court held:

> To succeed in a Rule 10b-5 suit, a plaintiff must show that the defendant used, in connection with the purchase or sale of any security, [any] *one of the four kinds of manipulative or deceptive devices to which the Rule refers*, and must also satisfy certain other requirements not at issue here.

Id. (emphasis added).

Finally, the Court addressed Wharf's policy argument that holding it liable would open the door to "numerous

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necessary to the Court's holding in that case. As explained above, *Central Bank* holds that what the statute proscribes can only be determined by reference to the statutory language, which is considerably more inclusive than the foregoing statement, on which *amici* believe Respondents nonetheless are likely to rely.

plaintiffs to bring federal securities claims that are, in reality, no more than ordinary breach-of-contract claims—actions that lie outside the Act's basic objectives." *Id.* at 596. The Court observed that "Wharf has not shown us that its concern has proved serious as a practical matter in the past." *Id.* at 597. It then added: "Nor does Wharf persuade us that it is likely to prove serious in the future," *id.*, and cited in support of this proposition the strict pleading requirements of the PSLRA, including the requirement that a complaint must state facts that support a strong inference that each defendant acted with scienter.

In *SEC v. Zandford*, 535 U.S. 813 (2002), a unanimous Court again held that Section 10(b) and Rule 10b-5 make it unlawful to engage not only in the manipulative and deceptive acts and practices to which the Court alluded in passing in *Central Bank*, but also in other acts and practices that fall within the broadly worded prohibition of the statute and rule. The Court pointed out that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id.* at 820. Rather, the Court held that Zandford's practice of selling his client's securities and then pocketing the proceeds "was properly viewed as a 'course of business' that operated as a fraud and deceit on [his] customer." *Id.* at 821.

In sum, in all three cases in which the Court has interpreted Section 10(b) since *Central Bank*, the Court has construed the statute to prohibit acts and practices that are outside the Eighth Circuit's overly narrow reading of *Central Bank*. The correct reading of *Central Bank*, as these cases make clear, is that Section 10(b) prohibits the direct or indirect use or employment of all manipulative and deceptive devices and contrivances, including those barred by subsections (a) and (c) of Rule 10b-5.

III. INNOCENT COUNTERPARTIES ARE PROTECTED FROM LIABILITY UNDER SECTION 10(b) BECAUSE THEY DO NOT USE OR EMPLOY MANIPULATIVE OR DECEPTIVE DEVICES AND BECAUSE THEY LACK SCIENTER

Lower courts that have upheld the theory of scheme liability post-*Central Bank* also have developed meaningful distinctions between aiding and abetting and scheme liability. In numerous cases, they have also dismissed some or all of the claims against secondary defendants, which demonstrates that scheme liability can be imposed in a manner consistent with *Central Bank*'s holding that liability cannot be imposed on one who does no more than aid and abet the violation of another.

For example, in *Parmalat*, Judge Kaplan held that two banks which factored and securitized invoices that they knew to be worthless used deceptive devices or contrivances in violation of Section 10(b). 376 F. Supp. 2d at 504. "The transactions in which the defendants engaged were by nature deceptive. They depended on a fiction, namely that the invoices had value." *Id.* By contrast, the same court dismissed claims based on allegations that the banks made loans which Parmalat improperly accounted for as equity investments or assets in its financial statements. *See id.* at 505. "In each of these cases, what remains when the bluster is stripped away are financings and investments. These transactions were not shams. . . . Any deceptiveness resulted from the manner in which Parmalat or its auditors described the transactions on Parmalat's balance sheets and elsewhere." *Id.* Judge Kaplan explained why the scheme liability allegations that he upheld were consistent with *Central Bank*:

> This analysis is not an end run around *Central Bank*. If a defendant has committed no act within

> the scope of Section 10(b) and Rule 10b-5 – as in fact was the case in *Central Bank* – then liability will not arise on the theory that that defendant assisted another in violating the statute and rule. But where, as alleged here, a financial institution enters into deceptive transactions as part of a scheme in violation of Rule 10b-5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under Section 10(b) and Rule 10b-5.

376 F. Supp. 2d at 509-10. A commercial counterparty cannot be liable unless it engages in deceptive conduct with scienter.

Similarly, the Ninth Circuit held in *AOL Time Warner* "that to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." 452 F.3d at 1048. The court held that this test comports with *Central Bank* because "[t]he focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only those defendants who use or employ a manipulative or deceptive device) are held liable under the Act." *Id.* at 1049. The Ninth Circuit's test genuinely protects both innocent counterparties and counterparties who engage in legitimate transactions that they know or believe will be misrepresented by others. In *AOL Time Warner*, Homestore.com allegedly agreed to purchase shares in other companies for inflated values or to purchase products or services it did not need, in exchange for the other companies' buying advertising from AOL, which, in turn, paid over much of the revenue to Homestore.com. *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1023 (C.D. Cal. 2003), *rev'd*, 452 F.3d

1040 (9th Cir. 2006). The Ninth Circuit held that under its test for scheme liability, plaintiffs failed to allege valid claims against AOL because it had a legitimate contractual relationship with Homestore.com and did not itself engage in any deceptive acts. *See* 452 F.3d at 1053. The AOL transactions were not mere shams, but rather had economic substance and became deceptive only after Homestore.com accounted for them incorrectly. *See id.*[8]

By contrast, the Enron case illustrates the danger that reading scheme liability out of Section 10(b) and Rule 10b-5 would immunize cunning parties who engage in deceptive conduct with the primary purpose and effect of creating a false appearance about an issuer's financial condition in connection with purchases and sales of securities, but carefully refrain from making direct misrepresentations to investors. *See Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *petition for certiorari filed*, No. 06-1341 (U.S. Mar. 5, 2007).[9] In the Enron case, plaintiffs alleged that several firms knowingly engaged in sham transactions with Enron that lacked any economic substance; for example, plaintiffs alleged that Merrill Lynch agreed to "buy" several electricity-generating barges in Nigeria from Enron at the end of Enron's fiscal year to enable it to book revenue and meet analysts' estimates, while at the same time Enron and Merrill Lynch entered into a secret side agreement whereby Enron would buy the barges back the following year at a profit to Merrill Lynch. *See* 482 F.3d at 377.

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8. The court reached the same conclusion as to other companies with which Homestore.com entered into legitimate transactions that Homestore.com then misrepresented in its financial statements.

9. The facts set forth in the petition for certiorari in the Enron case starkly illuminate the stakes of this Court's determination about the scope of scheme liability under Section 10(b) and Rule 10b-5.

Notwithstanding allegations that Merrill Lynch and the other bank defendants deliberately engaged in inherently deceptive conduct to create a false appearance about Enron's revenue and debt levels, the majority of a panel of the Fifth Circuit held that these defendants did not engage in "deceptive" conduct because they had no duty to disclose information to Enron's stockholders. *See id.* at 390.[10] Thus, the Fifth Circuit panel's majority effectively deleted subsections (a) and (c) from Rule 10b-5, leaving only Rule 10b-5(b)'s prohibition of material misrepresentations and omissions. The majority also failed to acknowledge this Court's holdings in *Zandford* that "conduct, without more" can constitute a deceptive device or contrivance under Section 10(b) and Rule 10b-5 and that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." 535 U.S. at 820-21. At the same time, the majority recognized that "the court's interpretation of § 10(b) could have gone in a different direction and might have established liability for the actions the banks are alleged to have undertaken," and that its decision "may not coincide . . . with notions of justice and fair play." 482 F.3d at 393. In the view of *amici*, the Fifth Circuit majority's decision cannot be

10. Judge Dennis of the Fifth Circuit concurred in the judgment reversing class certification, on the ground that the district court misinterpreted the PSLRA's joint and several liability provision and should reconsider whether common damages issues would predominate over individual issues under the correct standard. *See* 482 F.3d at 395 (Dennis, J., concurring in judgment). However, Judge Dennis identified the errors of the panel majority's "cramped interpretation of the statutory language of section 10(b)" and criticized the majority for "immuniz[ing] a broad array of undeniably fraudulent conduct from civil liability under Section 10(b), effectively giving secondary actors license to scheme with impunity." *Id.* at 394.

squared with the language of Section 10(b). Like the decision below, it reflects an overbroad reading of *Central Bank*.

This Court has given weight to the policy concern that securities litigation against secondary actors poses the risk of coercive settlements divorced from the merits of the cases. *See Central Bank*, 511 U.S. at 189. That concern, and more importantly the text of Section 10(b) and Rule 10b-5, justified *Central Bank*'s rejection of aiding and abetting liability. That concern should not and cannot justify negating the plain language of the statute and rule to eliminate primary liability of secondary actors who themselves knowingly engage in deceptive conduct in connection with purchases and sales of securities, especially because the requirement that the defendant itself have engaged in deceptive conduct, with scienter, will prevent non-meritorious claims.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including the securities regulators in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in connection with the offer and sale of securities.[1]

[1] Pursuant to SUP. CT. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity, other than NASAA, its members, or its counsel, made any monetary con-

The U.S. members of NASAA are responsible for administering state securities laws and regulations. Their activities include licensing broker-dealers, registering local securities offerings, and conducting compliance examinations. Especially important is their enforcement role: protecting the nation's investors by bringing literally thousands of enforcement actions every year against the firms and individuals who have committed fraud and abuse in connection with the sale of securities. In those cases, state securities regulators often seek restitution to help make injured investors whole, although the best hope of recovery for the vast majority of defrauded investors is through the courts in private actions for damages, not through governmental enforcement actions at either the state or federal level.

NASAA supports the work of its members through training programs, enforcement assistance, and legislative analysis. Another important role of the association is representing the membership's position as *amicus curiae* in significant cases brought by private plaintiffs as well as government regulators involving the interpretation of the securities laws and the rights of investors. *See, e.g.*, Brief of the North American Securities Administrators Association, Inc., as *Amicus Curiae*, in Support of Respondents, filed in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, Case No. 06-484 (U.S. Mar. 9, 2007) (supporting investors' position on the "strong inference of scienter" standard under the Private Securities Litigation Reform Act), *available at* http://www.nasaa.org/content/Files/Tellabs.pdf; Brief of *Amicus Curiae* North American Securities Administrators Association, Inc., in Support of the People of the State of California, filed in *People v. Edward D.*

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tribution to the preparation or submission of the brief. Pursuant to SUP. CT. R. 37.3, NASAA further represents that all parties to this appeal have consented to the filing of this *amicus* brief. The Petitioner's written consent is on file with the Court, and the Respondents' written consent accompanies this brief.

Jones & Co., Case No. CO53407 (Cal. Ct. App. Feb. 23, 2007), *available at* http://www.nasaa.org/content/Files/ED_JONES_FINAL.pdf.

NASAA and its members have an interest in the outcome of this appeal because it will profoundly affect the ability of investors to seek redress in cases where unscrupulous companies and individuals have actively participated with issuers in schemes to defraud the securities markets. The Eighth Circuit incorrectly held that any defendant who does not make a fraudulent misstatement or omission, or who does not engage in manipulative trading of securities, cannot be held liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The lower court adopted the narrow view that absent those specific forms of misconduct, a defendant is at most an aider and abettor immune from suit under *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). If this Court affirms the lower court and thus insulates a broad range of deceptive practices from the reach of Section 10(b), many victims of securities fraud with meritorious claims will lose the opportunity to recover damages resulting from undeniably culpable behavior. As advocates for the rights of investors to seek redress, NASAA and its members have an interest in supporting reversal and restoring an interpretation of the law that is more in keeping with its language, intent, and underlying purposes.

This Court's decision will also have a pivotal effect on the role of private actions as a deterrent against securities fraud. Private actions by defrauded investors are an enormously important complement to regulatory enforcement actions as a means of policing the securities marketplace. State and federal securities regulators work tirelessly to detect, enjoin, and punish financial fraud. However, private actions not only provide the principal means of compensation for victims of

securities fraud, they also play a vitally important role in protecting the integrity of the marketplace through deterrence, a fact often noted by this Court. *See, e.g., Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) (the private cause of action for violations of Section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements"). The burgeoning growth in large-scale securities fraud over the past decade shows that a broad interpretation of Section 10(b), in keeping with its remedial purposes, is just as important today as it was in 1934, perhaps more so. To the extent that the Court erects unwarranted barriers to recovery in private actions—such as immunity for those who participate in fraudulent schemes through deceptive acts, not words—the Court will undermine an important deterrent that benefits the marketplace as a whole. For this additional reason, NASAA and its members support reversal of the circuit court's decision.

SUMMARY OF THE ARGUMENT

The lower court erred when it dismissed the Petitioner's claims and held that Section 10(b) of the Exchange Act and Rule 10b-5 encompass only misstatements and omissions of material fact and not deceptive acts performed as part of a scheme to defraud the securities markets. The lower court's narrow construction conflicts with the plain language of the statute, Congress's intent that the antifraud provisions of the Exchange Act be construed broadly, and this Court's decisions recognizing that Section 10(b) applies to deceptive actions as well as misstatements and omissions.

The lower court also erred by ignoring the public policy implications of its interpretation of the law. The boundless ingenuity of those who commit fraud and the need to protect investors from fraud and abuse together make it imperative that Section 10(b) be applied to all types of deceptive devices. A decision that holds all parties accountable for their role in a

fraudulent scheme—regardless of whether their deception was perpetrated through words or deeds—will help repair the damage done to investors and deter future violations, without unduly burdening the legitimate industry. At a time when large scale financial fraud shows little sign of abating, this Court should ensure that injured investors have the opportunity to seek relief in federal court. For these reasons, the Court should reverse the lower court's decision and reinstate the Petitioner's claims.

ARGUMENT

I. THE RESPONDENTS CAN BE HELD PRIMARILY LIABLE UNDER SECTION 10(B) BECAUSE THE SHAM BUSINESS TRANSACTIONS THEY ENTERED INTO WERE "DECEPTIVE DEVICES" WITHIN THE MEANING OF THE STATUTE; SECTION 10(B) WAS WRITTEN TO ADDRESS DECEPTIVE CONDUCT AS WELL AS MISREPRESENTATIONS AND OMISSIONS OF MATERIAL FACT

Section 10(b) of the Exchange Act applies to the deceptive business transactions that the Respondents entered into with Charter Communications, Inc. ("Charter") to perpetrate a fraud on the securities market. The lower court held to the contrary and dismissed the Petitioner's claims, ruling that "[a] device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *In re Charter Communications, Inc., Sec. Litig.*, 443 F. 3d 987, 992 (8th Cir. 2006), *cert. granted*, 127 S. Ct. 1873 (Mar. 26, 2007).

The lower court erred. The plain language of the statute, its legislative history, and the decisions of this Court all show that Section 10(b) encompasses deceptive conduct as well as misstatements and omissions. Moreover, Section 10(b)

applies to *any* person that has used a deceptive device to perpetrate a fraud, regardless of whether that person is a corporate insider, an accountant, or simply an outside business partner. In this case, the Respondents participated in sham business transactions that had no economic purpose other than artificially inflating Charter's revenues and its stock price. Even if the Respondents did not publicly disseminate false statements reflecting those transactions, their deceptive conduct led to the same result—a fraud on the market. By virtue of these acts, the Respondents used "deceptive devices" within the meaning of Section 10(b). Accordingly, they should be held accountable as primary violators in a trial on the merits.

A. The Plain Words of Section 10(b) Encompass Deceptive Acts, Not Only Misrepresentations and Omissions

The lower court's narrow interpretation of Section 10(b) is not consistent with the plain language of the Exchange Act. The primary guide to the meaning of any statute is the language of the statute itself. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). This Court evaluates both the literal meaning of the words used in a statute, as well as their connotation, to ascertain Congress's intent. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 & n.20 (1976) (relying upon definitions and connotations of the words "device," "contrivance," and "manipulate" as the basis for its holding that Section 10(b) requires some degree of scienter). In this case, the wording of Section 10(b) plainly covers a broad spectrum of conduct in addition to misrepresentations and omissions. Congress made it unlawful for "any person, directly or indirectly, . . . to use or employ, . . . any *manipulative or deceptive device or contrivance*" in contravention of the SEC's rules and regulations. 15 U.S.C. § 78j(b) (emphasis added). The words "use," "employ," "device," and "contrivance" all have inher-

ently nonverbal definitions and connotations. *Cf. Ernst & Ernst*, 425 U.S. at 199 n.20. Further, the word "deceive" "implies deliberate misrepresentation of facts" by "actions" as well as "words." *See* WEBSTER'S NEW WORLD DICTIONARY (3rd ed. 1986). Congress's repeated use of the word "any" is another clear indication that the provision was intended to be broad and "inclusive." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972). Congress had no intention of limiting its comprehensive ban on fraud in Section 10(b) to strictly verbal utterances.

Congress's choice of more limited wording in other anti-fraud provisions of the securities laws underscores the intended breadth of Section 10(b). *Cf. Ernst & Ernst v. Hochfelder*, 425 U.S. at 206 (observing that the 1933 and 1934 Acts are interrelated components of a federal regulatory scheme, and comparing various provisions to ascertain Congressional intent with respect to scienter). For example, in Section 12(a)(2) of the Securities Act of 1933, Congress established civil liability for very a carefully defined type of fraud. The provision targets the offer or sale of a security "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances in which they were made, not misleading . . ." 15 U.S.C. § 77*l*(a)(2). Obviously, Congress knew how to target misrepresentations and omissions alone when it wanted to do so, and it is appropriate to infer that Congress intended something distinctive and broader in Section 10(b).

The legal context in which Congress drafted Section 10(b) also supports imposition of liability upon all those who participate in a fraudulent scheme through actions or words. The Exchange Act was intended not only to preserve all rights and remedies under the common law, but to strengthen those standards of conduct. *See* 15 U.S.C. § 78bb(a) (rights

and remedies provided under statute are in addition to "any and all other rights and remedies that may exist at law or in equity"); *Basic Inc. v. Levinson*, 485 U.S. 224, 244 n.22 (1988) (Rule 10b-5 actions were intended "to add to protections provided investors under the common law"); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388 (1983) ("important purpose of the federal securities acts was to rectify perceived deficiencies in the available common law remedies by establishing higher standards of conduct in the securities industry"). One of the attributes of the common law in 1934 was liability for those who participated in a fraud. *See* Robert A. Prentice, *Locating that "Indistinct" and "Virtually Non-existent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. Rev. 691, 753 (1997), and cases cited therein at nn.266 & 267 (the common law was very clear in holding that all participants in a fraudulent scheme—not just those who had direct contact with the victim—were liable to the scheme's victims). Given the Congressional desire to improve upon available remedies, Section 10(b) deserves an interpretation at least as broad as the common law doctrines prevailing at the time of enactment. By this measure, all participants in a fraudulent scheme who engage in deception can be held primarily liable.

Although the Court in *Central Bank* rejected a similar analysis as to aiding and abetting liability under Section 10(b), it did so because largely because it questioned whether aiding and abetting was really part of the common law. *See Central Bank*, 511 U.S. at 181-82. The Court did not, however, reject the general principle that, absent direct conflict with statutory language, the jurisprudence of Section 10(b) should be informed by the common law. *Cf. SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) (broad interpretation of the antifraud provisions in the Investment Advisers Act is supported by an evolution in the common law of fraud to encompass breach of fiduciary duty in securities transactions). In this case, there is no uncertainty

that the common law of fraud historically attached primary liability to all of the participants in a fraudulent scheme.

B. The Legislative History of the Exchange Act Makes Clear that Congress Intended Section 10(b) as a Flexible, Catchall Provision, to Be Applied to a Wide Variety of Fraudulent Schemes

The legislative history of the Exchange Act, although not extensive with respect to Section 10(b), supports a broad reading of the provision, one that covers a wide range of manipulative and deceptive conduct. The legislative reports describe the purpose of the law in terms of prohibiting "inequitable and unfair *practices*." *See, e.g.*, S. REP. NO. 73-792 (1934), 1934 WL 1289, at *1, *6 (also explaining that statute was aimed at "manipulative and deceptive practices"). Nowhere in the legislative history is there any language stating or suggesting that Section 10(b) was intended to cover only misstatements and omissions. Under this Court's decisions interpreting Section 10(b), the absence of such legislative history is a significant reflection of Congress's intent. *See Ernst & Ernst*, 425 U.S. at 202 (noting the absence of any legislative history supporting a negligence standard).

The legislative history also reveals that Congress intended Section 10(b) to be a "catchall" provision that would give the SEC authority to deal with "new manipulative devices." *See Ernst & Ernst*, 425 U.S. at 202 (quoting testimony); *see also* H. REP. NO. 73-1383 (1934), 1934 WL 1290, at *6-7 ("In a field where practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad administrative powers in the administrative agency have been found practically essential . . . ."). This Court's decisions reflect the same point: interpretations of the securities laws must be "capable of adaptation to meet the countless and variable schemes devised by

those who seek the use of the money of others on the promise of profits." *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

The constantly evolving nature of the securities markets and the need for a corresponding flexibility in the law has also influenced the Court's application of Section 10(b) in private civil actions. In *Basic Inc. v. Levinson*, the Court adopted a flexible approach to the element of reliance, allowing it to be presumed where a fraud has affected the market price upon which buyers and sellers rely. 485 U.S. 224, 247. The Court stated: "The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences." *Id.* at 243-44. In the words of the House Report:

> As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests . . . it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position.

See Prentice, 75 N.C. L. Rev. at 715-16 (quoting H. Rep. No. 73-1383, at 5 (1934)). The complex securities fraud alleged in this case illustrates the need to apply the law flexibly, as Congress intended.

C. SEC Rule 10b-5, Which Implements Section 10(b), Covers a Wide Range of Acts, Practices, and Schemes in Addition to Untrue Statements and Omissions

The interpretation of the regulatory agency charged with implementing Section 10(b) supports a broad reading of the statutory language. The SEC adopted Rule 10b-5 in accor-

dance with the Congressional directive set forth in Section 10(b). While subsection (b) of the Rule focuses exclusively on "untrue statements" and "omissions" of material fact, the other two subsections address much broader conduct, making it unlawful "to employ any device, scheme, or artifice to defraud," 17 C.F.R. § 240.10b-5(a), or "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit," 17 C.F.R. § 240.10b-5(c). Subsections (a) and (c)—also promulgated in accordance with Section 10(b)—address fundamentally broader types of fraud than the more narrowly written provisions of subsection (b) dealing with misrepresentations and omissions. It is true that the Rule cannot be read to cover more than what Congress intended to reach in Section 10(b) of the Exchange Act, because the SEC's rule making authority was circumscribed by the ambit of the statutory provision it was interpreting. *See Ernst & Ernst*, 425 U.S. at 213. However, the very broad language that Congress used to frame Section 10(b) left ample room for all of the unlawful activities enumerated in subsections (a) through (c) of Rule 10b-5. The SEC's Rule was therefore a reasonable and appropriate explication of the intended scope of the statute and as such, it deserves deference. *See Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837, 843-44 (1984).

D. The Decisions of this Court Support the Application of Section 10(b) to Deceptive Conduct Other than Misrepresentations and Omissions

The decisions of this Court support a finding that the phrase "deceptive devices" as it appears in Section 10(b) includes fraudulent acts, as well as misrepresentations and omissions. For example, in *SEC v. Zandford*, 535 U.S. 813 (2002), a client opened an investment account with a broker, for himself and his mentally retarded daughter. *Id.* at 815. Over a two year period, the broker engaged in a pattern of

selling the securities in the account and converting the proceeds for his own use. *Id.* at 815, 820. The focus of the Court's opinion was that the fraud occurred "in connection with the purchase or sale of [a] security," but the Court also held that the combined actions of selling the securities and converting the proceeds constituted a deceptive device under Section 10(b) and Rule 10b-5. The Court noted that the scheme was not authorized or disclosed to the client, but the Court viewed the conduct itself as sufficient to trigger application of Section 10(b) and the Rule: "Indeed, each time respondent 'exercised his power of disposition for his own benefit,' that conduct, 'without more,' was a fraud." *Id.* at 821 (citation omitted).

The Court in *Zandford* also dismissed the argument that the sale of securities and the conversion of funds were independent events. The Court found that the two elements of the scheme were sufficiently linked to support application of Section 10(b) because the sales were effected for the ultimate purpose of converting the proceeds. *Id.* at 820. Similarly in this case, the Respondents engaged in deceptive business transactions for the ultimate purpose of creating fictitious revenues on Charter's books and shoring up Charter's stock price. Under the reasoning in *Zandford*, such deceptive devices fall within the scope of Section 10(b).

In *Superintendent of Insurance v. State of New York*, 404 U.S. 6 (1971), the Court held that Section 10(b) and Rule 10b-5 were applicable to an elaborate scheme in which the defendants sold $5,000,000 worth of securities held by an insurance company, misappropriated the proceeds, and concealed the fraud in the company's books and records. The Court stated that the company "was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities." *Id.* at 10. Further emphasizing that the scheme was implemented largely through a series of fraudulent acts, not just misrep-

resentations, the Court observed: "The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor." *Id.* at 12-13. The Court was unconcerned that the "fraud was perpetrated by an officer of the corporation and his *outside collaborators*," *id.* at 10 (emphasis added), because Section 10(b) "bans the use of any deceptive device in the 'sale' of any security by 'any person,'" *id.*[2]

This Court's decision in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), also supports an interpretation of Section 10(b) that extends it to deceptive acts other than misrepresentations and omissions. In *Herman*, the Court held that a private action lies under Section 10(b) notwithstanding the availability of a remedy under Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, which prohibits false or misleading information in registration statements. *Id.* at 387. The Court observed that although Section 10(b) and Section 11 may overlap to some degree, they largely address different types of wrongdoing. *Id.* at 382. The Court emphasized that Section 11 could be invoked only against certain parties and only for fraud in registration statements. *Id.* The Court

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[2] The *Superintendent* case, coupled with the broad wording of Section 10(b), disposes of the lower court's suggestion that outside business partners engaged in "arms-length" transactions with issuers cannot be held primarily liable under the statute. *See In re Charter Communications, Inc.*, 443 F. 3d at 991, 992. Section 10(b) covers "any person" using deceptive devices, and the Exchange Act defines the term "person" expansively. *See* 15 U.S.C. 78c(a)(9). It does not limit liability to corporate insiders or professional consultants that have special duties to the company. Even this Court's decision in *Central Bank* recognized the potential liability of outside entities under Section 10(b). It cautioned that the elimination of aiding and abetting liability did not insulate all secondary actors from primary liability under Section 10(b), and noted that "any person or entity" may be liable, provided all the requirements of the statute and the Rule are met. *Central Bank of Denver, N.A.*, 511 U.S. at 191. The Court cited lawyers, accountants, and banks as examples, but not as an exhaustive enumeration of potentially liable secondary actors. *Id.*

explained that Section 10(b) was, "[i]n contrast," a "catchall" antifraud provision, under which "action can be brought by a purchaser or seller of '*any* security' against '*any* person' who has used '*any* manipulative or deceptive device or contrivance' in connection with the purchase or sale of a security." *Id.* at 382 (emphasis in original) (citations omitted).

The Court further explained that limiting the scope of Section 10(b) would immunize any parties—such as corporate officers, lawyers, and accountants—who did not prepare or certify the registration statements but who nevertheless may have engaged in "*fraudulent conduct* while participating in the registration statement." *Id.* at 387 n.22 (emphasis added). In the Court's view, such a result would conflict with the plainly broad language of Section 10(b), and with the rule that securities laws combating fraud should be construed broadly to achieve their remedial purposes. *Id.* at 387-88. In keeping with the decision in *Herman* and Congress's legislative intent, this Court should not immunize parties such as the Respondents, who may not have issued Charter's false financial reports, but who nevertheless participated in the development of those reports through fraudulent conduct.

Some lower federal courts have endorsed the application of Section 10(b) to deceptive conduct as well as misrepresentations and omissions. In *Simpson v. AOL Time Warner, Inc.*, 452 F. 3d 1040 (9th Cir. 2006), the investors alleged that an internet-based real estate company engaged in complex "barter" or "round-trip" transactions with its business clients for the purpose of inflating its revenues. *Id.* at 1043. The Ninth Circuit Court of Appeals articulated the following test for determining whether a defendant may be held liable as a primary violator of Section 10(b): "If a defendant's conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud, then the defendant is using or employing a deceptive device within the meaning of

§ 10(b)." *Id.* at 1050. The court explained that in contrast, "participation in a legitimate transaction, which does not have a deceptive purpose or effect, would not allow for a primary violation, even if the defendant knew or intended that another party would manipulate the transaction to effectuate a fraud." *Id.*

The court emphasized the importance of examining "the deceptive nature of the defendant's own conduct" as a means of differentiating primary violators from mere aiders and abetters, who cannot be found liable under Section 10(b). *Id.* at 1049. The court ultimately dismissed the complaint, with leave to seek amendment, because the allegations failed adequately to aver that the business client's transactions were illegitimate or had created false appearance of fact. *Id.* at 1052-53. However, the court's analysis nevertheless demonstrated that applying Section 10(b) to *deceptive conduct* is at least one principled way of attaching primary liability to those who participate in a fraudulent scheme, while at the same time respecting this Court's prohibition against aiding and abetting liability under *Central Bank*. *See also In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) (denying a motion to dismiss for outside business partners who devised sham corporate entities to hide expenses and overstate profits).[3]

In this case, of course, the Respondents' transactions with Charter were not legitimate and they undoubtedly created a false appearance: that the surcharge for each cable box was a

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[3] The court in *Simpson* also correctly held that the required element of reliance is present in deceptive conduct cases "if the introduction of misleading statements into the securities market was the intended end result of a scheme to misrepresent revenue." 452 F. 3d at 1051. In this case, the introduction of false revenue reports into the marketplace was the intended result of the Respondents' scheme, so the element of reliance is present.

capital expense, and that the return of the surcharge to Charter in the guise of advertising fees was genuine revenue. Accordingly, the Respondents used deceptive devices within the meaning of Section 10(b). *But see Regents of the Univ. of Calif. v. Credit Suisse First Boston (USA), Inc.*, 482 F. 3d 372, 388 (5th Cir. 2007) (disagreeing with the Ninth Circuit's approach in *Simpson* and holding that deception within the meaning of Section 10(b) is limited to a misstatement or a failure to disclose by one who has a duty to disclose).

The lower court in this case relied upon *Central Bank* and *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), as the basis for its narrow reading of Section 10(b), but in neither of those cases did this Court restrict the application of Section 10(b) to misstatements and omissions. In *Central Bank*, the Court held that the text of Section 10(b) "does not itself reach those who aid and abet a § 10(b) violation." *See* 511 U.S. at 177. In dicta, the Court paraphrased the broad language of Section 10(b) as a prohibition against "the making of a material misstatement (or omission) or the commission of a manipulative act." *Id.* at 177. This isolated observation was not an element of the Court's holding, and it was contradicted by other language in the opinion more accurately characterizing Section 10(b) in terms of "manipulative or deceptive acts." *Id.* at 177-178.

Nor does *Santa Fe* stand for the proposition that Section 10(b) is confined to misstatements and omissions. In *Santa Fe*, minority shareholders alleged they had received undervalued stock from majority shareholders during a merger. The majority shareholders had fully complied with the applicable state merger law, and had fully disclosed the terms of the merger, including the share price and the method used for its computation. 430 U.S. at 466, 469. The Court affirmed dismissal of the complaint, holding that a breach of fiduciary duty by itself, without any deception of any kind, did not comprise a violation of 10(b). *Id.* at 475-76. In the words of

the Court, "We thus adhere to the proposition that 'Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.'" *Id.* at 479 (citation omitted). Although the Court ruled that some form of deception is an essential element of a claim under Section 10(b), the Court also quite clearly understood the concept of deception in a broad sense, one that allowed for deceptive conduct as distinct from misstatements and omissions. For example, in rejecting the plaintiffs' contention, the Court observed that "The cases do not support the proposition . . . that a breach of fiduciary duty by majority shareholders, without any *deception, misrepresentation, or nondisclosure,* violates the statute and the Rule." *Id.* at 476 (emphasis added); *see also id.* at 473 ("The language of § 10(b) gives no indication that Congress meant to prohibit any *conduct* not involving manipulation or deception.") (emphasis added).

All of the foregoing authorities confirm that the plain language and the intended scope of Section 10(b) is broad enough to encompass the Respondents' conduct in this case. The sham transactions they entered into with Charter were "deceptive devices" because they created the false impression that Charter was making bona fide capital expenditures and receiving bona fide revenues in its transactions with the Respondents. In fact, the arrangement had no financial significance whatsoever. Moreover, the Respondents engaged in the deceptive scheme for the ultimate purpose of artificially inflating the market price of Charter's stock, to the detriment of public shareholders. The allegations against the Respondents in this case therefore describe the use of "deceptive devices" to commit securities fraud, in violation of Section 10(b).[4]

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[4] In this case, although the Respondents did not engage in wash sales on an exchange, they did enter into what can certainly be described as "wash" business transactions that had the specific purpose and effect of generating fictitious revenue reports that in turn artificially supported the market price of Charter's shares. *See In re Charter Communications, Inc.,*

II. THE NEED TO PROTECT INVESTORS, BOTH IN THIS CASE AND MORE GENERALLY, SUPPORTS REVERSAL OF THE LOWER COURT'S NARROW INTERPRETATION OF SECTION 10(B)

The lower court based its decision in part on considerations of public policy. The court asserted that imposing liability on the Respondents for deceptive conduct would "introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings," a policy decision that the court viewed as a matter best left to Congress. *In re Charter Communications, Inc.*, 443 F. 3d at 992-93. The lower court's concerns were unfounded. Applying Section 10(b) to the type of deceptive business deals that the Respondents entered with Charter will impose no duties or uncertainties, other than those that arise from the universal and entirely fitting obligation to refrain from using deceptive devices in schemes to commit securities fraud. Even more important is the lower court's failure to consider *any* of the investor protection policies underlying the securities acts. Those interests justify a broad reading of Section 10(b), not a restrictive interpretation that immunizes participants in a securities fraud.

A. Section 10(b) Is to Be Applied Broadly and Flexibly to Achieve its Objectives

Congress passed the Exchange Act in 1934 as part of an aggressive legislative response to extensive fraud and abuse in the securities markets. The overriding purpose of the

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Sec. Litig, No. MDL 1506, 4:02-SV-1186 CAS, WL 3826761, at *3 (E.D. Mo. Oct. 12, 2004) ("the price increases paid by Charter and 'advertising payments' made by the vendors constituted 'wash' transactions with no economic significance"). The Respondents were full and witting partners in these deceptive transactions and were therefore primary actors in the fraudulent scheme.

statute is to protect investors, and since 1934, this Court has declared again and again that the federal securities laws should be interpreted broadly and flexibly to achieve that remedial purpose. *See generally SEC v. Zandford*, 535 U.S. 813, 819 (2002). Applying this rule of statutory construction in the securities field, the Court has expansively interpreted many facets of Section 10(b): the misconduct that it prohibits, the securities that trigger its application, and the elements of a violation. *See SEC v. Zandford*, 535 U.S. 813 (applying Section 10(b) to sale of client's securities and conversion of proceeds); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (rejecting narrow interpretation of materiality with respect to merger negotiations and recognizing a presumption of reliance in cases involving fraud on the market); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (broadly defining investment contracts as securities).

B. Congress and the Courts Regard Private Actions Under Section 10(b) as an Especially Important Mechanism for Advancing the Goal of Investor Protection

In these and other decisions, the Court has recognized a strong Congressional policy favoring private actions as a means of achieving the investor protection goals underlying the securities laws. Private actions afford victims of fraud the best and often only hope of recovering their losses—something government enforcement actions are ill-equipped to do on a large scale. Private actions are also an essential deterrent because governmental enforcement program simply cannot, by themselves, inspire compliance with the law. *See generally Pinter v. Dahl*, 486 U.S. 622, 633 (1988) (recognizing the "congressional policy favoring private suits as an important mode of enforcing federal securities statutes"); *Basic Inc. v. Levinson*, 485 U.S. 224, 245 (1988) (noting that presumption of reliance facilitates Rule 10b-5 litigation and therefore supports the congressional policy embodied in the

1934 Act); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (denying application of *in pari delicto* defense and observing that "private actions provide 'a most effective weapon in the enforcement' of the securities laws") (citations omitted).

In some cases, the Court has recognized limits on the application of these policies and has declined to adopt a broad interpretation of the securities laws. Where for example, the text of a statute simply does not permit a broad interpretation, the Court has subordinated the policy of investor protection to the text of the law as written. This was the principal rationale for the Court's unwillingness to recognize aiding and abetting liability in *Central Bank*. *See* 511 U.S. at 173, 177 (holding that "the text of the statute controls our decision" and adding that the issue "is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute").[5] Similarly, where Congress has deliberately tempered private rights of action through amendments to the securities laws, as it did in the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the Court has respected those limits as well. *See Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005) (PSLRA makes clear Congress's intent to permit recovery in private action only where plaintiffs adequately allege causation and loss).

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[5] In *Central Bank*, the Court actually did consider policy implications. It speculated that uncertainty surrounding the scope of aiding and abetting liability might cause legitimate service providers in the securities industry to fall victim to strike suits and to respond by either withholding their services or passing increased costs on to clients and shareholders. *See* 511 U.S. at 189. These concerns are not relevant here because little uncertainty surrounds the use of deception as the test for primary liability. Moreover, shortly after *Central Bank*, Congress addressed the problem of strike suits in the Private Securities Litigation Reform Act of 1995.

No such statutory limitations apply in this case, however. The wording of Section 10(b) poses no obstacle to the theory of liability advanced by the Petitioner in this case. To the contrary, the broad phrasing of Section 10(b) easily accommodates the Respondents' deceptive acts. In PSLRA, Congress instituted heightened pleading requirements, limits on discovery, and other measures aimed at inhibiting abusive strike suits, but it chose *not* to restrict the nature of the "manipulative or deceptive" devices constituting fraud under Section 10(b), nor did it limit the category of "persons" subject to its antifraud provision.[6] *See* 15 U.S.C. § 78u-4. In short, neither the securities laws nor the decisions of this Court can justify a narrow interpretation of Section 10(b) in this case. The Court therefore should give full sway to the dual goals of deterring securities fraud and allowing investors to recover their losses.

C. Allowing the Petitioner's Claims to Proceed Will Further the Deterrent and Remedial Goals of the Exchange Act

Applying Section 10(b) to the type of deceptive conduct at issue in this case will serve these important policies. A holding that views the Respondents' conduct as falling within the scope of Section 10(b) will help deter similar violations by others who are tempted to participate in fraudulent schemes. We are in an era when companies feverishly strive to bolster

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[6] In PSLRA, Congress felt compelled to address the problem of abusive lawsuits, but it also recognized, and sought to preserve, the beneficial role of private actions in combating securities fraud: "Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action." *See* H.R. CONF. REP. NO. 104-369 (1995), 1995 WL 709276, at *31. Moreover, Congress recognized that "[s]uch private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers *and others* properly perform their jobs." *Id.* (emphasis added).

publicly announced revenues to sustain their share prices, often by issuing fraudulent financial statements. Companies have partnered not just with their accountants, but also with their investment banks (as in Enron) and their outside vendors (as in this case) in deceptive schemes designed to add credibility and camouflage to those misleading reports. The Court in *Central Bank* acknowledged that in complex securities fraud cases, "there are likely to be multiple violators." *See* 511 U.S. at 191. Allowing investors to seek recourse in such cases will discourage the participation of such consultants and outside business partners in fraudulent schemes.

Reversal of the lower court's narrow interpretation of Section 10(b) will also help investors recover their losses arising from securities fraud. Often the companies directly responsible for the dissemination of false financial statements have collapsed under the weight of the fraud, leaving the other participants in the scheme to answer for the losses that investors have suffered. By exposing all parties responsible for the fraud to civil liability, the law will afford at least some chance of recovery to those who have lost their investments—often their life savings—as a result of the defendants' culpable behavior.

D. Giving Investors Fair Access to the Courts Is Vital Given the Rise in Fraud, the Statutory Limitations that Congress Has Already Placed on Private Actions, and the Lack of Alternative Remedies Under State Law

The need to ensure that investors have meaningful private remedies in federal court has become especially acute as a result of the enactment of PSLRA in 1995. Since then, there has been a marked rise in the incidence of corporate accounting fraud and securities law violations affecting large classes of investors. Congress recognized the seriousness of the problem, and the need for at least a partial legislative

response, when it enacted the Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201-7266. The House Report accompanying the House bill aptly describes the problem of deceptive corporate practices that harm investors:

> The collapse of the Enron Corporation provided irrefutable evidence of serious, systemic problems in our financial reporting system and our capital markets. Far from being an isolated instance, Enron was only the most spectacular example of what has become a common phenomenon—earnings manipulation and deceptive accounting by our largest companies. Before Enron, company after company—Waste Management, Sunbeam, Cendant, W.R. Grace, and many others—were found to have manipulated their accounting to present a picture to investors that did not match reality. As evidenced by the record number of investigations opened by the SEC thus far this year [2002], the problem has only become more acute.

See H.R. REP. NO. 107-414 (2002), 2002 WL 661614, at *47 (Minority Views);[7] *see also, e.g.*, Press Release, No. 2002-179, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices (SEC, Dec. 20, 2002), *available at* http://www.sec.gov/news/press/2002-179.htm; Press Release, State Investigation Reveals Mutual Fund Fraud (Office of New York Attorney General, Sept. 3, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

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[7] For the most part, the laudable provisions of Sarbanes-Oxley are focused on enhancing the regulatory oversight of corporate accounting practices and toughening the penalties for violations of the securities laws. *See, e.g.*, Title I, 15 U.S.C. §§ 7211-19 (establishing an accounting oversight board for public companies); Title VIII, Section 807, 18 U.S.C. § 1348 (increasing criminal penalties for defrauding shareholders of publicly traded companies). It remains for the courts to interpret the securities laws in a manner that affords investors an adequate means of redress for corporate malfeasance.

Those violations have harmed millions of investors nationwide, inflicting huge personal losses. Yet the number of securities fraud class action lawsuits filed in the federal courts has declined, and dismissal rates have increased since PSLRA was enacted. *See generally Hearing on H.R. 5491, Before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises*, 109th Cong. (2006) (Statement of James D. Cox), *available at* http://www.law.duke.edu/features/pdf/coxtestimony.pdf; Ronald I. Miller, Todd Foster, and Elaine Buckberg, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?* Apr. 2006, *available at* http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf (National Economic Research Associates, Inc.).

These conflicting trends have prompted experts in the securities field to surmise that because of PSLRA, "the balance has been tipped too far in favor of preventing claims (some of which would, after discovery, turn out to have merit) rather than protecting investors who have suffered losses. That is, Congress swung the pendulum too far in protecting defendants." Kevin S. Schmelzer, *The Door Slammed Shut Needs to be Reopened: Examining the Pleading Requirements Under the Private Securities Litigation Reform Act*, 78 Temp. L. Rev. 405, 426 (2005); *see also* Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. Cin. L. Rev. 95, 113 (2004) ("the diminution in the effectiveness of private federal securities litigation was one of the several facts that contributed to a reduction in fraud deterrence."). In short, Congress has adopted legislative measures that are more than adequate to protect industry from abusive lawsuits. Where claims of fraud lie well within the statutory boundaries that Congress has set, as they do here, there is no justification for a narrow interpretation of the law that further limits the ability of investors to seek relief.

Federal relief is all the more important when state law does not provide an alternative remedy. This Court has observed that the disadvantages posed by a restrictive interpretation of federal securities law can be "attenuated" where adequate remedies are available under state law. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n.9 (1975) (weighing fact that class action in state court was an alternative remedy); *see also Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 478 (1977) (state cause of action under corporate law was a factor in determining whether to recognize federal cause of action); *J.I. Case Co. v. Borak*, 377 U.S. 426, 434-35 (1964) (noting that if federal jurisdiction is limited and state affords no relief, then the "whole purpose" of the statutory provision might be frustrated). Conversely, where state law does not offer a significant alternative forum for plaintiffs' claims, there is a correspondingly greater justification—and need—for the federal courts to afford relief.

In this case, state law offers limited recourse for investors in the Petitioner's position. Congress has expressly limited the use of class action suits seeking recovery for securities fraud under state law. In 1998, Congress enacted the Securities Litigation Uniform Standards Act ("SLUSA") to address the concern that "securities class action lawsuits [had] shifted from Federal to state courts" as a means of circumventing PSLRA. *See* Notes, 15 U.S.C.A. § 78a (excerpt from Congressional findings in Pub. L. 105-353, § 2, Nov. 3, 1998). With certain exceptions, SLUSA provides that no class action based upon state law may be maintained in any state court on behalf of more than 50 class members. *See* 15 U.S.C. § 77p(b). Moreover, state courts generally have not recognized the doctrine of fraud-on-the-market in cases seeking relief under state common law, further limiting the state courts as an alternative forum for investors aggrieved by large-scale market manipulation of the sort alleged in this case. *See, e.g., Peil v. Speiser*, 806 F.2d 1154, 1163 (3rd Cir. 1986) (no states have adopted fraud on the market theory);

Kaufman v. i-Stat Corp., 754 A.2d 1188, 1193-94 (N.J. 2000); *Mirkin v. Wasserman*, 858 P.2d 568, 584 (Cal. 1993).

Precisely because of the massive corporate frauds that have surfaced in recent years, some courts have recognized the need to re-evaluate barriers to civil actions alleging securities fraud. The California Supreme Court, for example, has cited the troubling increase in corporate fraud as a reason to recalibrate the balance between the interests of investors and the interests of corporations, in favor of providing greater judicial recourse to victims of fraud:

> When Congress enacted the Private Securities Litigation Reform Act of 1995 and the Uniform Standards Act of 1998, it was almost entirely concerned with preventing nonmeritorious suits. (Stout, supra, 38 Ariz. L. Rev. 711). But events since 1998 have changed the perspective. The last few years have seen repeated reports of false financial statements and accounting fraud, demonstrating that many charges of corporate fraud were neither speculative nor attempts to extort settlement money, but were based on actual misconduct. "To open the newspaper today is to receive a daily dose of scandal, from Adelphia to Enron and beyond. Sadly, each of us knows that these newly publicized instances of accounting-related securities fraud are no longer out of the ordinary, save perhaps in scale alone." (Schulman, et al., The Sarbanes-Oxley Act: The Impact on Civil Litigation under the Federal Securities Laws from the Plaintiff's Perspective (2002 ALI-ABA Cont. Legal Ed.) p.1.) The victims of the reported frauds, moreover, are often persons who were induced to hold corporate stock by rosy but false financial reports, while others who knew the true state of affairs exercised stock options and sold at inflated prices. (See Purcell, The Enron Bankruptcy and Employer Stock in Retirement Plans, Congressional Research Service (Mar. 11, 2002).) Eliminating barriers that deny redress to actual victims

> of fraud now assumes an importance equal to that of deterring nonmeritorious suits.

See Small v. Fritz Companies, Inc., 65 P. 3d 1255, 1263-64 (Cal. 2003).

As financial crimes abound and as alternative forums for aggrieved investors remain limited, it is especially important that the federal courts interpret federal law in a way that, to the extent possible, affords meaningful remedies to victims of securities fraud. Reversing the lower court's decision will help accomplish this objective.

CONCLUSION

For the reasons set forth above, the decision of the United States Court of Appeals for the Eighth Circuit should be reversed.

Respectfully submitted,

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No. 06-43

In the Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF OHIO, TEXAS AND *30* OTHER STATES AND COMMONWEALTHS AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether shareholders can recover damages from actors who, acting with the requisite intent to deceive, actively engage in conduct that has the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud the securities market, even when the actor has made no false statement or omission and otherwise owes no fiduciary duty to the shareholders.

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INTRODUCTION

This case has been described as "probably the most important legal issue for the securities industry in a generation."[1] The Court's decision here will profoundly affect not only the market as a whole, but investors large and small, and the faith that those investors will have in the market for years to come. The amici States urge the Court to support a healthy securities market, and the investors who rely on it, by overruling the Eighth Circuit below.

Our nation's system of monitoring fraud and eliminating it from the securities market relies on two fundamental presumptions: (1) wrongdoers disrupting the market should be held accountable for their bad acts and (2) those wronged should be compensated for their losses.[2] Violators of the securities laws therefore face the prospect of both criminal and civil liability for their conduct, with cases being prosecuted by state and federal securities regulators as well as by individual and class plaintiffs acting as "private attorneys general." Over time, this system has promoted market integrity, bolstered investor confidence, and made American markets what they are today: the global leaders "set[ting] the standard for the rest of the world."[3] This case poses the question whether the law will continue to protect the markets by providing a remedy for the wrongs suffered as the result of fraudulent corporate schemes under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.

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[1] Christopher S. Rugaber, *Court to consider 'scheme liability' in Stoneridge suit against Motorola, Scientific-Atlanta*, Associated Press (Mar. 26, 2007) (quoting Robert Giuffra, attorney at law firm Sullivan & Cromwell).

[2] Keith L. Johnson, *Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors*, 60 Law & Contemp. Probs. 155 (Autumn 1997).

[3] Christopher Cox, Chairman, Sec. Exch. Comm'n, Remarks to the U.S. Chamber of Commerce's First Annual Capital Markets Summit: Securing America's Competitiveness (Mar. 14, 2007).

§78(j)(b), and SEC Rule 10b-5, 17 C.F.R. §240.10b-5. Investors (and other interested parties) here and abroad are anxiously awaiting the answer.

Petitioner Stoneridge Investment Partners, LLC ("Stoneridge") and Respondents Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") offer the Court two competing answers to the question. Stoneridge has argued that wrongdoers should be held liable for damages as primary violators under Rule 10b-5(a) and (c) where they participate in a "scheme or artifice to defraud" or by "engaging in a 'course of business which operates . . . as a fraud or deceit.'" *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (*In re Charter Commc'n, Inc. Sec. Litig.*) ("*Stoneridge*"), 443 F.3d 987, 991 (8th Cir. 2006). In Stoneridge's view, the defendant need not make misleading statements or omissions to be held liable; participating in a sham transaction with no legitimate business or economic purpose and with the requisite scienter should suffice. *Stoneridge*, Brief of Appellant Stoneridge, 2005 U.S. 8th Cir. Briefs Lexis 1974, at *22-31 (June 14, 2005).

On the other hand, Scientific-Atlanta and Motorola have argued that a defendant must make a misleading statement or omission to be held liable under Section 10(b) or Rule 10b-5 and, thus, scheme defendants who remain silent and owe no duty of candor to investors are categorically exempt. *Stoneridge*, Brief of Appellee Scientific-Atlanta, 2005 U.S. 8th Cir. Briefs Lexis 1974, at *10-13 (Aug. 15, 2005); *Stoneridge*, Brief of Appellee Motorola, Inc., 2005 U.S. 8th Cir. Briefs Lexis 1974, at *19-24 (Aug. 15, 2005).

The circuit courts considering the issue are split. The Ninth Circuit, in the *Homestore* case, articulated a test in line with Stoneridge's position, whereby participants in schemes with the "principal purpose and effect" of defrauding investors are held liable whether or not they made misleading

statements or omissions to investors. *Simpson v. AOL Time Warner, Inc.* (*In re Homestore.com, Inc. Sec. Litig.*) (*"Homestore"*), 452 F.3d 1040, 1048 (9th Cir. 2006). By contrast, the Eighth Circuit in *Stoneridge* and the Fifth Circuit in *Enron* have adopted Scientific-Atlanta and Motorola's narrow interpretation of scheme liability based on an erroneous interpretation of this Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). See *Stoneridge*, 443 F.3d at 992; *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.* (*"Enron"*), 482 F.3d 372, 387 (5th Cir. 2007).

Amici States urge the Court to adopt our approach, which follows the Ninth Circuit's *Homestore* holding and, in this case, Stoneridge's position. This is the proper standard because the plain language of Section 10(b) and Rule 10b-5 reflects Congress's purpose that no defendant should be immune from scheme liability when that defendant possesses the requisite intent to deceive and actually engages in conduct that does in fact deceive investors. Indeed, our system of monitoring and eliminating securities fraud would be severely undermined if, as the Fifth Circuit recently ruled, the parties who "could have pulled the plug on Enron" get to walk away. *Enron*, 482 F.3d at 392. Neither the spirit nor the letter of the securities laws allows culpable individuals or companies actively participating in fraud schemes to escape liability for their actions. The amici States urge the Court to grant Stoneridge relief by reversing the Eighth Circuit's decision below.

INTEREST OF AMICI STATES

Amici States have an interest in the outcome of this appeal for several reasons. First, the States themselves are investors, representing some of the largest institutional investors in the world. In almost every case involving the scheme liability issue presented here, a state pension fund is

either lead plaintiff, opt-out plaintiff, or a class member with significant losses.[4]

Second, the amici States are uniquely sensitive to the plight of their small, individual investors. While the PSLRA has shifted the focus and responsibility for private securities fraud class actions to large institutional investors like state pension funds, it is often the small, individual investor who loses the most. For when the Enrons of the world go bankrupt, it is the States who come to these investors' aid as they face the day-to-day consequences of losing their jobs, homes, and life savings as a direct result of securities fraud.

Finally, amici States have a direct interest in the integrity and competitiveness of the securities markets from a public-protection standpoint. Fraudulent actors of all types must be deterred for the markets to function properly. The Court should reverse the decision of the Eighth Circuit to maintain this deterrence.

SUMMARY OF THE ARGUMENT

Amici States make three principal points. First, amici States demonstrate that culpable parties will be improperly shielded from liability if the Eighth Circuit is affirmed. This group includes the unprincipled accountants, lawyers, and banks, as well as unscrupulous vendors, who, even if they did not make misleading statements or omissions themselves, nonetheless intended to deceive and engage in sham

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[4] For example, in Ohio, two large state pension funds recently lost a motion to dismiss a defendant bank based primarily on the Eighth and Fifth Circuit scheme liability rulings at issue here. *In re Fannie Mae Sec. Litig.*, No. 04-1639, 2007 U.S. Dist. Lexis 33939, at *18-25 (D.D.C. May 8, 2007). Those same funds, plus two other Ohio funds, are also awaiting a ruling against defendant banks Merrill Lynch, Credit Suisse First Boston, and Barclays in a securities opt-out action, pending the related appeal to this Court of the Fifth Circuit's opinion in *Enron*. See *Pub. Empls. Ret. Sys. of Ohio v. Fastow (In re Enron Corp. Sec. Litig.)*, Case No. 02-CVH09-977, MDL-1446 (S.D. Tex. Mar. 20, 2007).

transactions. In the Enron frauds alone these "non-speaking" defendants made billions of dollars in ill-gained profits. Amici States oppose a rule that would allow defendants to escape liability and retain these profits. Significantly, the Court in *Central Bank* has already foreshadowed that these types of parties should be held liable under appropriate circumstances.

Second, amici States point out the other side of securities fraud cases: the victims. Amici States pay dearly in their own right as holders of large institutional pension funds in securities fraud schemes. But the most tragic cases are the individual investors who lose everything they own. These small investors need to recover at least some of the money they lose as a result of fraudulent schemes. All fraudulent actors, including those remaining silent, should contribute to these victims' recoveries.

Third, the amici States contend that "non-speaking" actors should be held liable for a primary violation of Section 10(b) where those actors, intending to deceive, actively participate in a "scheme to defraud" in which the principal purpose and effect of the scheme is to create a false appearance or statement of fact in furtherance of the scheme. It is not necessary for such actors to personally make the false statement or omission. This is the standard adopted by the Ninth Circuit in *Homestore*, and it is the standard that best accomplishes the dual purposes of the securities laws—to punish wrongdoers and compensate victims. Amici States accordingly urge the Court to overrule the conflicting Eighth and Fifth Circuit decisions.

ARGUMENT

A. Eliminating scheme liability for "non-speaking" actors will improperly exempt culpable banks, lawyers, accountants, vendors, and other non-issuing entities who all must be deterred for the securities regulation system to function properly.

The plain language of the securities laws—§ 10(b) and Rule 10b-5—expressly prohibits all deceptive devices and manipulative schemes involving the sales of securities. That is precisely the guarantee and protection that amici States advocate here. The Court need look no further than the facts of *Stoneridge*, *Homestore*, and, of course, *Enron* to see the reasons these protections should be maintained.

1. *Stoneridge*

In *Stoneridge*, two major cable equipment vendors (Scientific-Atlanta and Motorola) "accepted and returned" $20 payments from cable communications company Charter Communications, Inc., in exchange for free advertising to Charter's more than 6.4 million cable customers in 40 states.[5] See *Stoneridge*, 443 F.3d 987, 990 (8th Cir. 2006); *In re Charter Communications, Inc.*, 2004 U.S. Dist. Lexis 29647, at *15 (E.D. Mo. 2004). As these figures suggest, Charter was one of the largest cable-communications companies in the country and a lucrative source of business for both Scientific-Atlanta and Motorola.

According to the *Stoneridge* complaint, Scientific-Atlanta and Motorola worked directly with Charter in crafting the sham transactions and knew that Charter was using the "payments" to dupe investors into believing Charter was

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[5] See Charter Communications Holdings, LLC, Form 10-K for year ended December 31, 2000, at 4 (filed with Securities and Exchange Commission on April 2, 2001).

meeting the operating-cash-flow expectations of Wall Street analysts. In its opinion, the District Court for the Eastern District of Missouri noted several allegations indicating that "high level personnel" of both Scientific-Atlanta and Motorola were in fact "direct participants in the scheme":

- In August 2000, to cover a year-end operating-cash-flow shortfall of $15-$20 million, Charter's CEO and COO instructed John Pietri, Charter's Senior Vice-President of Engineering, to lobby Scientific-Atlanta and Motorola (the "vendors") to purchase time-slot advertising. The vendors had no interest.

- Pietri's superiors instructed him to approach the vendors again, this time with sham business transactions that would generate the appearance of operating-cash-flow growth for Charter. Charter offered to pay the vendors an additional $20 per set top box, provided the vendors would "return" the $20 payment to Charter. Charter would, in turn, give them free advertising. The vendors agreed. As a result, Charter's operating cash flow was inflated by $17 million and the vendors received their respective shares of $17 million worth of free cable advertising.

- Executives from both vendors worked directly with Pietri to fabricate documentation giving the transactions the appearance of valid arms-length business transactions.

In re Charter Communications, Inc., 2004 U.S. Dist. Lexis 29679, at *10-17 (E.D. Mo. 2004).

Assuming the allegations above are true, both Scientific-Atlanta and Motorola were active and knowing participants in the scheme to defraud and should be held equally liable for the harm the scheme caused Charter and its investors. In fact, the particularities of Charter's accounting scheme were sufficiently egregious to yield felony guilty pleas, probation

and prison time, and hefty fines for four of Charter's former executives.[6] Moreover, on the civil side, ten of Charter's key executives and Charter's independent auditor Arthur Anderson, LLP, paid a collective $144 million in cash and stock to settle class-action claims against them.[7] Scientific-Atlanta and Motorola, however, who both received millions in free advertising and millions more in equipment sales contracts, have incurred no criminal or civil penalties for their roles in the scheme. *Stoneridge*, 443 F.3d at 990.

The end result in *Stoneridge*, absent intervention by the Court, is that Scientific-Atlanta and Motorola retain their millions in ill-gotten gains, while Charter investors are unable to recover their millions in outstanding losses. Moreover, Scientific-Atlanta and Motorola can earn millions more in the next sham business transaction without penalty. Other cable equipment vendors also will be enticed to engage in these bogus but profitable transactions. Congress did not intend this result in passing the Securities Exchange Act of 1934; PSLRA, 15 U.S.C. §78u-4 *et seq.*, which expressly provides for proportionate and limited joint and several liability; or SLUSA, 15 U.S.C. §78bb(a).

2. Homestore

In *Homestore*, an Internet company engaged in more complicated "barter" or "round-trip" schemes with multiple companies to overstate its revenues by more than $170 million. *Homestore*, 452 F.3d at 1042. The other companies allegedly participating in the scheme were AOL Time Warner, Cendant Corporation, and L90.

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[6] Cheryl Wittenauer, *Charter Communications Executives Sentenced In Accounting Schemes*, The Detroit News, Apr. 23, 2005 www.detnews.com/2005/business/0504/23/biz-159359.htm; John Gibeaut, *An Outside Shot at Securities Fraud*, A.B.A. J. June 2007.

[7] *Id.*

According to the complaint, AOL was the first company to take fraudulent advertising commissions from Homestore. Homestore agreed to purchase shares in a thinly capitalized third party at an inflated price in exchange for that company's agreement to pass virtually all of that money to AOL in the form of "advertising fees." AOL, in turn, would share the advertising "revenue" with Homestore. The result was a fraudulent "triangular transaction" in which Homestore funneled money through the third party and AOL and back to itself as needed to meet analysts' revenue expectations.

Homestore's alleged scheme with Cendant was much simpler, though no less profitable. Homestore "grossly overpa[id]" Cendant $750 million for the purchase of the Web site Move.com, contingent on Cendant's promise to funnel some of the money back to Homestore. As with the money funneled through AOL, Homestore recorded the Cendant payment as "revenue" to meet analyst expectations. Cendant set up a separate corporate entity, Real Estate Technology Trust, which paid $95 million to Homestore for products and services following the Move.com sale. It is not clear how much of the remaining $655 million Cendant retained from the "sale" as its "commission."

L90's participation was similar to AOL's: funneling funds through a third party. Homestore's auditor became suspicious and required a confirmation letter from L90 before it would certify Homestore's 10-Q securities filing. L90 had already earned millions in fraudulent commissions before Homestore restated its financials.

As was the case with Charter, criminal and civil charges were quickly filed against Homestore and its executives. Eleven Homestore employees, including its former COO, CFO, and VP of Finance, were convicted of federal offenses in relation to the scheme. Homestore's CEO was convicted of conspiracy, insider trading, and falsifying corporate records

and SEC reports and received a 15-year prison sentence and $5 million fine for his part.[8] On the civil side, Homestore and several of its officers paid approximately $19 million in cash plus 20 million shares of stock in settlement while Homestore's auditor, PriceWaterhouseCooper, doled out an additional $17.5 million to Homestore investors.[9] AOL, Cendant, and L90, on the other hand, have not yet been held liable for their conduct. Following the Ninth Circuit's holding in *Homestore*—and unlike the "non-speaking" actors in *Stoneridge*—these entities *can* be held liable and compelled to pay their fair share, regardless of whether they personally made a false statement or omission.[10]

3. *Enron*

The well-known *Enron* case equally illustrates the reasons why the Eighth Circuit should be reversed. Numerous players were involved in the schemes that ultimately brought down the Houston corporate giant, among them nine of the largest banks and brokerage firms on Wall Street: J.P. Morgan Chase, Citigroup, Canadian Imperial Bank of Commerce ("CIBC"), Bank of America, Deutsche Bank, Lehman Brothers, Credit Suisse First Boston ("Credit

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[8] Press Release, U.S. Dep't of Justice, *Ex-CEO of Homestore.com Sentenced to 15 Years in Federal Prison for Orchestrating Scheme That Illegally Inflated Company's Revenue* (Oct. 12, 2006), http://losangeles.fbi.gov/dojpressrel/pressrel06/la101206usa.htm.

[9] Homestore.com, Inc. Class Action Settlement Information Website, "Q&A," http://www.homestoresettlement.com/questions.shtml (last visited June 11, 2007).

[10] To this point, the litigation in *Homestore* has not yet established whether AOL, Cendant, and L90's conduct, as a factual matter, constituted active participation in a deceptive scheme whose principal purpose and effect was to create a false statement of fact in furtherance of the scheme as the *Homestore* decision requires. 452 F.3d at 1054-55.

Suisse"), Merrill Lynch & Company, Inc. ("Merrill Lynch"), and Barclays Bank PLC ("Barclays").[11] Together, the banks and brokerages raised $6 billion for Enron through fraudulent debt and stock issues from 1996 through 2001 plus an additional $4 billion they channeled into Enron's sham partnerships Jedi, Chewco, LJM1 and LJM2.[12] The banks and brokerages themselves earned hundreds of millions individually—billions collectively—in commissions, consulting fees, and inflated interest. Moreover, select senior managers from the banks personally pocketed millions by investing their own money in Enron's "special entities" that promised returns of 1,000 percent or more.[13]

One of the Enron schemes relevant to this appeal is the "Nigerian Barges Transaction." According to the *Enron* complaint, Enron "sold" its interest in electricity-generating barges off the coast of Nigeria to Merrill Lynch with a side agreement to "buy back" that interest from Merrill Lynch six months later at a 20% premium. As was the case in *Stoneridge* and *Homestore*, the Enron plaintiffs allege that Merrill Lynch knew that Enron was using the sham transaction to inflate its revenues in its year-end financial statements.[14] 482 F.3d at 392. The Fifth Circuit held that

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[11] Press Release, University of California, *Banks, law firms, were pivotal in executing Enron securities fraud*, http://www.ucop.edu/news/enron/art408.htm (Apr. 8, 2002).

[12] *Id.*

[13] *Id.*

[14] There is evidence to support that allegation, which the Fifth Circuit specifically noted in its opinion. 482 F.3d at 377 n.1 (quoting e-mail between Merrill Lynch employees regarding the effect the Nigerian Barge transactions had on Enron's stock price and Enron executives' personal compensation). However, Plaintiffs will not get the opportunity to obtain additional evidence regarding Merrill Lynch's knowledge or alleged involvement in the scheme unless the Fifth Circuit is reversed.

Merrill Lynch owed no duty to Enron investors and is free of liability. *Id.*[15]

Although the Fifth Circuit lamented that Merrill Lynch and the other banks "do, after all, escape liability for alleged conduct that was hardly praiseworthy," the ultimate message the Fifth Circuit opinion sends to the banks who did not settle (and to Enron investors) is that there is no legal recourse for wrongs committed by "non-speaking" actors. *Id.*[16]

In sum, unless the court below is reversed, unscrupulous actors will keep the billions in ill-gotten gains and will continue to engage in profitable but illicit transactions. That is neither what Congress intended in the securities fraud laws nor what this Court intended in deciding *Central Bank*. Amici States urge the Court to reverse the Eighth Circuit's decision below.

B. Eliminating scheme liability for "non-speaking" actors will significantly diminish victims' right to compensation under the securities laws.

Enron's employees and retirees are probably the best-known victims of fraudulent securities practices. When the company collapsed, more than 4,000 Houston employees lost their jobs, and approximately 20,000 employees and retirees

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[15] On the criminal side, the Fifth Circuit also overturned the convictions of four former Merrill Lynch executives actively engaged in the Nigerian Barges Transaction. John C. Roper, *4 Ex-Merrill Lynch Execs' Convictions Overturned*, Houston Chron., Aug. 2, 2006, at A1.

[16] Credit Suisse had allegedly engaged in a similar sham transaction, known as "Osprey." 482 F.3d at 377 n.1 (quoting email between Credit Suisse employees acknowledging *"Osprey is a vehicle enabling Enron to raise disguised debt which appears as equity on Enron's balance sheet . . . ."* (emphasis added)).

lost $1.3 billion in their 401(k) accounts.[17] What is worse, the "employees most at risk were those who had expressed the most faith in Enron by putting their own contributions into Enron stock." Like most employees of large public companies, Enron employees had "the vast majority of their assets in Enron stock."[18]

Janice Farmer was one of those employees. "I was proud to invest in Enron stock," she said in testimony before a U.S. Senate committee. "We were a loyal and hardworking group of employees. We lived, ate, slept and breathed Enron because we were owners of the company. I trusted the management of Enron with my life savings."[19] Ms. Farmer lost $700,000. Charles Prestwood was another Enron employee. He saw his retirement nest egg dissolve almost instantaneously, from $1.3 million to $8,000:

> All Charles Prestwood wanted was to travel beyond Texas. All he wanted was an employer that wouldn't destroy his 401(k), a financial system to keep his employer honest, and, now, judges to hold that employer and those banks liable for the theft of his old age. "I cannot understand judges who would look at the people who designed the theft, provided the money to do it and drove the getaway car, and say that they didn't do anything. This country boy."

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[17] Damien Cave, *401 Reasons to Love Enron*, Salon, Jan. 17, 2002, http://air.salon.com/story/tech/feature/2002/01/17/401l/index.htm

[18] *Id.* Enron employees had invested 60% of their assets in company stock, which is not unusual. Procter & Gamble employees invest 94% of their assets in company stock, Sherwin-Williams employees invest 90% of their assets in company stock, and Coca-Cola employees invest 81% of their assets in company stock. *Id.*

[19] Quoted in Christopher Ketcham, *Enron's Human Toll*, Salon, Jan. 23, 2002, http://air.salon.com/story/tech/feature/2002/01/23/enron_to l /index .html.

he says, "has a hard time interpreting these things."[20]

The only way for victims such as Ms. Farmer and Mr. Prestwood to recover anything at all in catastrophic bankrupting frauds like Enron is for culpable "non-speaking" actors to be held liable. Virtually all of the record $7.1 billion settlement to investors in Enron came from "non-speaking" actors: CIBC, $2.4 billion; JP MorganChase, $2.2 billion; Citigroup, $2 billion; Lehman Brothers, $222.5 million; and Bank of America, $69 million.[21] Without those funds, many individual Enron shareholders would have received nothing; and without "scheme liability," many more defrauded investors will receive nothing. The amici States therefore urge the Court to reverse the Eighth Circuit and allow investors to recover from all culpable actors who actively engage in securities fraud schemes, regardless of whether they personally made a material misstatement or omission.

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[20] Harold Meyerson, *Enron's Enablers: The Finance Firms That 'Drove the Getaway Car'*, Wash. Post, May 9, 2007, at A17.

[21] Press Release, University of California, *UC and Enron Investors Join Coalition Urging the SEC to Protect Investors and Hold Banks Accountable For Securities Fraud*, http://www.universityofcalifornia.edu/news/2007/may09.html (May 9, 2007).

C. Liability for "non-speaking" actors in a securities fraud scheme should turn on the principal purpose and effect of those actors' own conduct and their culpability, not whether those actors personally made (or successfully avoided public attribution of) a false statement or omission.

1. The plain language of § 10(b) does not limit liability to actors making public statements or omissions.

The federal securities laws, on their face, hold *any* person liable for *any* manipulative or deceptive device or contrivance. The language does not make distinctions based on title, profession, or industry; does not immunize any category of persons or entities; and, importantly, does not limit liability to actors making public statements or omissions. The language of the principal anti-fraud provision of the federal securities laws is extremely broad. Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful, "directly or indirectly" for "any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or . . . contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe." Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j)(b).[22]

In addition, the Court has held that §10(b) broadly prohibits the use of any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities, including manipulation or deception as part of a

---

[22] In defining liability for securities fraud under § 10(b), the Court must "turn first to the language of § 10(b), for 'the starting point in every case involving construction of a statute is the language itself.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (*quoting Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)).

larger scheme to defraud the broader securities market. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, at 199 (1976). In fact, in the context of a fiduciary relationship, the Court has already held that that a non-speaking actor who engages in a scheme to defraud has used or employed a deceptive device within the meaning of § 10(b). *SEC v. Zandford*, 535 U.S. 813, 821-22 (2002). Moreover, the Court has recognized that deception can be undertaken in a variety of ways other than through false statements or omissions. In *Ernst & Ernst*, the State Court stated that "device" broadly means "an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and that "contrivance" means any "thing contrived or used in contriving; a scheme, plan, or artifice." 425 U.S. at 199 n.20 (quoting Webster's International Dictionary (2nd ed. 1934)).

However, in its decision below, the Eighth Circuit categorically and improperly held that a "device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *Stoneridge*, 443 F.3d at 992 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-75 (1977)). The Eighth Circuit's interpretation of § 10(b) is not supported by the statute's text. Neither § 10(b) nor related provisions make any reference to public statements or omissions, but instead broadly prohibit the use of *any* "manipulative or deceptive device or contrivance" connected to the securities market.

In determining that deceptive conduct must involve "either a misstatement or a failure to disclose by one who has a duty to disclose," the Eighth Circuit improperly relied on this Court's decision in *Santa Fe*. The *Santa Fe* Court decided issues related to breach of fiduciary duty under Rule 10b-5--not broader scheme liability under § 10(b). The primary holding of the *Santa Fe* decision was that "breach of fiduciary duty by majority stockholders, without any

deception, misrepresentation, or nondisclosure, [does not violate] the statute and the Rule." 430 U.S. at 475-76. Indeed the *Santa Fe* Court's separate references to deception, misrepresentation, and nondisclosure indicate that deceptive conduct may take forms other than statements or omissions: "Congress [in enacting § 10(b)] meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices." *Id.* at 477. The Eighth Circuit's decision below cannot be squared with either the statute's text or this Court's clear statements regarding the breadth of § 10(b), and must be reversed.

Given the plain language of § 10(b) and the definitions set forth by the Court, and regardless of statements or omissions by the parties, amici States urge that conduct that has the core purpose and effect of creating a false impression in the securities realm can constitute a "manipulative or deceptive device or contrivance" under § 10(b). As articulated by the Ninth Circuit in *Homestore*, 452 F.3d at 1052, the plain language of § 10(b) necessitates "that conduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b)."

2. The plain language of Rule 10b-5 does not limit liability to actors making public statements or omissions.

Section 10(b) expressly authorizes to the Securities and Exchange Commission to define "manipulative or deceptive devices or contrivances" through "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. §78(j)(b). The SEC first exercised this authority in 1942 by adopting Rule 10b-5 to specify three overlapping yet

distinct categories of manipulative or deceptive devices or contrivances:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

17 C.F.R. §240.10b-5. Only subsection 10b-5(b) provides that the defendant make a deceptive misstatement or omission. In contrast, subsections 10b-5(a) and (c) curtail conduct and behavior, rather than statements. "To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-53 (1972).

Thus, under the plain language of Rule 10b-5, a person or other entity may be held liable for any of the following:

1. Employing a device to defraud;[23]
2. Employing a scheme to defraud;[23]
3. Employing an artifice to defraud;[23]
4. Making any untrue statement of a material fact;[24]

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[23] 17 C.F.R. §240.10b-5(a).

[24] 17 C.F.R. §240.10b-5(b).

5. Omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;[24]

6. Engaging in an act which operates or would operate as a fraud or deceit upon anyone;[25]

7. Engaging in a practice which operates or would operate as a fraud or deceit upon anyone;[25] or

8. Engaging in a course of business which operates or would operate as a fraud or deceit upon anyone.[25]

Thus, the SEC rules themselves indicate that a statement or omission is not necessary to establish a primary violation of 10b-5.

Consistent with the inclusive language of both the statute and the Rule, the Court has repeatedly emphasized the extensive anti-fraud purposes of the federal securities laws. See, e.g., *Zandford*, 535 U.S. 813 (emphasizing broad language and interpretation of anti-fraud provisions and citing cases); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (noting that Congress intended "to insure honest securities markets and thereby promote investor confidence"); *Affiliated Ute Citizens*, 406 U.S. at 151 (holding that proscriptions of § 10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive").

The Court has noted that the 1934 Act and its companion legislative enactments embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

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[25] 17 C.F.R. §240.10b-5(c).

"We do not think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.'" *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). "Novel or atypical methods should not provide immunity from the securities laws." *Id.* Thus, § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, even if some of the actors involved did not make untrue statements or omit to make material statements.

3. *Central Bank* supports the proposition that actors using or employing a manipulative or deceptive device may be liable as primary violators of Section 10(b) or Rule 10b-5.

Liability for using or employing a manipulative or deceptive device is not barred by the Court's decision in *Central Bank*. In that case, the parties conceded that the defendant did not commit any act or practice under § 10(b). The *Central Bank* Court did not explore what constitutes a primary violation under the statute. See 511 U.S. at 191. Rather *Central Bank* held only that liability does not attach for merely aiding and abetting a primary violation.

The *Central Bank* Court expressly said that "[a]ny person or entity including a lawyer, accountant, or bank, . . . may be liable as a primary violator under Rule 10b-5." *Id.* "The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts." *Id.* Even more to the point, *Central Bank* did not strike down any language in § 10(b) or Rule 10b-5 or sweep away the extremely broad anti-fraud purposes of the federal securities laws.

The Court held in *Central Bank* only that, to be liable, a defendant must itself employ one or more of the eight types

of manipulative or deceptive devices or contrivances specified in Rule 10b-5, rather than merely assist another in doing so. In other words, *Central Bank* concerned the relationship or connection between the defendant and the fraudulent conduct; it did not alter the definition of the fraudulent conduct itself. See *id.* at 167 (question before Court was "whether private civil liability under § 10(b) extends as well to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation"). *Central Bank* did not address or alter the basic concept that any person or entity may be liable as a primary violator of § 10(b) or Rule 10b-5.

Nonetheless, Respondents interpret *Central Bank* to allow an actor to escape liability for participation in a securities fraud as long as he is crafty enough to carefully avoid the public attribution to him of a false statement. Respondents' interpretation and expansion of *Central Bank* will result in virtual immunity from private liability for culpable banks, law firms, accountants, and other actors in many cases. And their interpretation directly conflicts with both the broad language and purposes of § 10(b) and Rule 10b-5.

Indeed, it is precisely with respect to such schemes that the anti-fraud provisions are needed the most. The amici States urge the Court to continue to hold liable those "behind the scenes" actors who participate in and benefit from fraudulent schemes but avoid making misleading statements or omissions.

4. "Non-speaking" actors are subject to primary liability so long as their own conduct contributing to the scheme has a deceptive purpose and effect.

Since *Central Bank*, the principal duty of the courts in scheme-liability cases has been to determine what constitutes a "primary violation" of § 10(b). In *Central Bank*, the Court

held that liability under § 10(b) attaches only to "primary violators" and that there can be no liability for merely "aiding and abetting" a violation. 511 U.S. at 191. The amici States urge the Court to set forth a test for such liability based on two important and discrete showings: first, the defendant must possess the requisite intent to deceive, i.e., the same level of scienter required of all primary violators; and second, the defendant must have actively participated in a scheme whose principal purpose and effect was to create a false appearance of fact in furtherance of that scheme.

a. Primary liability under Section 10(b) and Rule 10b-5 may attach to "non-speaking" actors for false statements and omissions, even if the actors did not personally make the statement or omission.

After *Central Bank*, the courts have taken two general approaches to scheme liability under § 10(b)—the "substantial participation" standard and the "bright line" standard. Some courts have held that "substantial participation . . . in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the [false] statements." *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); see also *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628-29 (9th Cir. 1994). Under this "substantial participation" approach, to establish primary liability for a "non-speaking" actor it must be shown that: (1) the defendant either made a misrepresentation or omission, or "substantially participated" in the preparation of a misrepresentation made by someone else; and (2) the defendant knew or should have known that the misrepresentation or omission would be relied on by

investors, but public attribution of the "non-speaking" actor's role is unnecessary.[26]

Conversely, under the "bright line" approach, adopted by the Eighth Circuit below, to establish primary liability it must be shown that: (1) the defendant itself actually made a materially false or misleading statement (or omitted a material fact while under a duty to disclose); (2) the defendant knew or should have known that the misrepresentation or omission would be relied on by investors; and, at least according to a few courts, (3) the misstatement was attributed to the defendant at the time of its dissemination.

Neither test requires that the alleged violator actually directly communicate misrepresentations to the plaintiffs for primary liability to attach. See *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 964-72 (C.D. Cal. 1994) (employing "substantial participation" approach) ("[L]iability under Section 10(b)/Rule 10b-5 is not limited to the making of materially false and misleading statements or omissions . . . ."); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 171-76 (2d Cir. 1998), cert. denied 525 U.S. 1104 (1999) (employing "bright line" approach) ("There is no requirement that the alleged violator directly communicate misrepresentations to plaintiffs for primary liability to attach.") (quoting *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-27 (10th Cir. 1996) (same)). Rather, the defendant need have only known or recklessly disregarded

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[26] Several federal district courts also have adopted this view. See, e.g., *Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1287-91 (D. Utah 1999); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1400 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 971-72 (C.D. Cal. 1994); *Hill v. Hanover Energy, Inc.*, No. 91-1964 (JHG), 1991 U.S. Dist. Lexis 18566 (D.D.C. Dec. 16, 1991); *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 676 F. Supp. 458, 467-70 (S.D.N.Y. 1987).

the fact that its misrepresentation or omission would be relied on by investors. See *McGann v. Ernst & Young*, 102 F.3d 390, 397 (9th Cir. 1996), *cert. denied* 520 U.S. 1181 (1997) (employing "substantial participation" approach); see also *McNamara v. Bre-X Minerals Ltd.*, No. 5:97-CV-159, 2001 U.S. Dist. Lexis 4571, at *131 (E.D. Tex. Mar. 30, 2001) (employing "substantial participation" approach). Thus, neither test requires that the alleged violator actually directly communicate misrepresentations to plaintiffs for primary liability to attach. Therefore, some significant role in the preparation or creation of a misstatement that is directly communicated to investors by another party can suffice for primary liability under either post-*Central Bank* test.

A few "bright line" courts have adopted—with no valid basis—the additional requirement that, whether the defendant's statement is communicated directly to investors or indirectly through others, the defendant's statement must be attributed to the defendant by name to be actionable. See *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205-12 (11th Cir. 2001); *Wright*, 152 F.3d at 171-76. Courts that have adopted the attribution requirement have done so on the mistaken assumption that imposing liability on a defendant when the investors did not know of the defendant's involvement in the misrepresentation negates the requisite element of reliance. But that reasoning is flawed. Plaintiffs certainly can rely on a statement without knowing exactly who made it. And, reliance can exist even when the statement was not signed by the defendant or when the defendant was not identified by name.

Moreover, nothing in *Central Bank* mandates the conclusion that the concept of "making an untrue statement" is limited to signing such a statement or having such a statement identify its speaker by name. In fact, the Supreme Court recognized in *Central Bank* that liability requires reliance on a misrepresentation, not on a misrepresentation

that is identified as the statement of a particular person: "Any person or entity, including a lawyer, accountant, or bank, who . . . makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191. If the word "indirectly" in § 10(b) and Rule 10b-5 means anything, it certainly should cover the situation where a defendant creates a misrepresentation but carefully avoids being publicly identified with it. Fraudulent misrepresentations should not be immune from liability just because their creator is concealed. Otherwise, every culpable "non-speaking" actor would easily avoid liability simply by conditioning its services on remaining anonymous in any public statements.

b. Primary liability may attach to a "non-speaking" actor for participation in a scheme to defraud if (1) the scheme had the principal purpose and effect of creating a false appearance of fact and (2) the actor's own conduct contributing to the scheme had a deceptive purpose and effect.

As explained above, § 10(b) specifically authorizes the SEC to set forth rules and other interpretive parameters of § 10(b)'s reach. Thus, where appropriate, courts should look to and give deference to the Commission's interpretation of § 10(b) as set forth in Rule 10b-5. See *Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984). Thus, the SEC's "interpretation of the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable." *Zandford*, 535 U.S. at 819-20.

Notably, in the SEC's amicus brief in *Homestore*, on which the federal district court relied in *Enron*, the SEC recognized two points critical to the analysis here. First, the

SEC noted that "where a wrongdoer, intending to deceive investors, engages in a deceptive act as part of a scheme to defraud, he can cause the same injury to investors, and the same deleterious effects on the market regardless of whether he designed the scheme." *Newby v. Enron Corp.*, No. H-01-3624 2006 U.S. Dist. Lexis 43146 at *164-65 (S.D. Tex. June 5, 2006). And second, the SEC stated that the "deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as by words." *Id.*

In its amicus brief, the SEC further elaborated that "a 'deceptive act' includes a transaction whose principal purpose and effect is to create a false appearance of revenue which can be accomplished by acts as well as by words." *Id.* at *167. The Ninth Circuit in *Homestore* agreed with the SEC's position that "[a]ny person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator." 452 F.3d at 1048.

In contrast, the court below adopted a new version of the "bright line" test as to scheme liability, whereby "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10(b)-5." *Stoneridge*, 443 F.3d at 992. But this standard is not supported by either the text of, or the SEC's interpretation of, the statute and rule.

The amici States agree with the Ninth Circuit's interpretation of § 10-b and Rule 10b-5 as reflected in the *Homestore* opinion. Under that standard, "non-speaking" actors like Scientific-Atlanta, Motorola, AOL, Cendant, and

L90 will be held liable when they actively participate in schemes with both the principal purpose and effect of defrauding investors. Unlike the standard adopted by the Fifth and Eighth Circuits, which allows culpable banks, lawyers, accountants and others to escape liabil ty for fraudulent transactions, the Ninth Circuit standard supported here will deter individuals and companies from engaging in fraudulent activities when similar opportunities to defraud investors arise in the future.

CONCLUSION

For the above reasons, amici States ask the Court to reverse the Eighth Circuit's decision below.

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF ORGANIZATION FOR INTERNATIONAL INVESTMENT, INTERNATIONAL CHAMBER OF COMMERCE AND FEDERATION OF GERMAN INDUSTRIES AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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U.S. Chamber of Commerce, *Commission on the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations* (Mar. 2007) (*available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.htm) 13

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INTERESTS OF THE *AMICI CURIAE*

Amici curiae are international business associations with substantial common interests in ensuring stable and predictable legal regimes affecting international trade and investment.[1] In aggregate, the organizations filing this brief represent a substantial proportion of all foreign entities doing business in the U.S. The *amici* are umbrella organizations charged with representing the legal and policy interests of their members and, as such, regularly file briefs in the U.S. as *amici curiae* in cases such as this one that raise issues of vital concern to the foreign business community. Although the *amici* rarely file a brief in a case that does not directly address foreign trade, they have decided to do so here because of the significant impact a ruling in this case could have on foreign companies that seek to do business in the United States.

The Organization for International Investment ("OFII") is the largest business association in the U.S. representing the interests of U.S. subsidiaries of multinational companies before all branches and at all levels of government. OFII's member companies operate throughout the U.S., employing hundreds of thousands of workers in thousands of plants and locations throughout the country, as well as in many foreign countries, and are affiliates of companies transacting business in countries around the world.

The International Chamber of Commerce ("ICC") is the world business organization representing thousands of companies, chambers of commerce and business associations in 130 countries. Among other functions, the ICC promotes

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[1] No party's counsel wrote this brief (in whole or in part), and no person other than *amici* and their counsel contributed monetarily to this brief's preparation or submission. Petitioner's letter consenting to the filing of this brief is on file with this Court. Respondent's letter consenting to the filing is attached.

voluntary rules governing the conduct of business across borders that are observed in countless thousands of transactions every day; provides essential trade-related services such as the ICC International Court of Arbitration, the world's leading arbitral institution; and consults on issues of international trade for the United Nations and its specialized agencies.

The Federation of German Industries ("BDI") is the umbrella organization for all industrial businesses and industry-related service providers in Germany. It represents 37 industrial sector federations and has 15 regional offices in Germany. The BDI speaks for more than 100,000 private enterprises employing about eight million people.

Collectively, the members of the *amici* contribute substantially to the U.S. economy through investment and in commercial dealings with U.S. public companies. In 2006, the cumulative value of foreign direct investment ("FDI") in the U.S. was $1.874 trillion. This amount is equivalent to 15% of the U.S. gross domestic product ("GDP"). Direct investment capital inflows totaled $183.6 billion in 2006, $109.9 billion in 2005, and $133.2 billion in 2004. In addition, U.S. affiliates of foreign companies that are more than 50% owned by foreign investors employed 5.3 million U.S. workers in 2003, accounting for 4.7% of total private industry employment.

In connection with this activity, the members of *amici* engage in thousands of transactions each year with publicly traded companies in the U.S. The question presented by Petitioner in this case – whether counterparties to a transaction with a public company can be held liable for that company's misrepresentations to investors under Section 10(b) – is thus of fundamental importance to the members of *amici*.

SUMMARY OF ARGUMENT

Petitioner and its *amici* urge a broad expansion of liability under Section 10(b). Under Petitioner's proposed rule, anyone who participates in a transaction that has the "purpose and effect" of creating "a false appearance of material fact in furtherance of [a] scheme" can be held liable. Pet. Br. at i. This position should be rejected, as it would improperly permit aiding and abetting and conspiracy liability under Section 10(b).

The practical effect of Petitioner's position, if accepted, would be that any company that enters into a general commercial transaction could be held liable to a counterparty's shareholders under Section 10(b) if its counterparty misreports the transaction on its own financial statements. This result would obtain even though the "non-speaking" company correctly accounted for the transaction in its own financial statements and neither made representations nor owed any duties to the counterparty's shareholders.

This brief is not designed to provide a comprehensive discussion of the merits (or lack thereof) of Petitioner's "scheme" liability theory and "purpose and effects" test. Instead, *amici* seek to highlight that from the perspective of foreign companies in particular, Petitioner's view of Section 10(b) liability is unworkable, unpredictable, and plainly inconsistent with this Court's ruling in *Central Bank* and with the express intent of Congress. By virtue of its sweeping and ill-defined scope, it would convert parties to commercial transactions – including foreign companies in overseas transactions with U.S. entities – into *de facto* auditors of their U.S.-listed counterparty's financial statements, tasked with ensuring that their counterparty properly accounts for the transaction. Foreign companies, which generally do not employ U.S. GAAP, are particularly ill-suited to the task.

As a consequence, the imposition of scheme liability would have a material chilling effect on the willingness of foreign

companies to engage in general commercial transactions with publicly-listed U.S. companies. Numerous studies indicate that many companies avoid publicly registering their securities in the United States due to the costs and risks associated with the U.S. legal system. The rule Petitioner proposes would take this problem one step further by making foreign and other companies more reluctant even to do ordinary business with companies that publicly list in the United States.

ARGUMENT

I. RESPONDENTS' LIABILITY UNDER SECTION 10(B) WOULD BE INCONSISTENT WITH THE DECISIONS OF THIS COURT AND CONGRESS

This Court in *Central Bank* rejected a private right of action under Section 10(b) against aiders and abettors, finding that Congress did not intend the statute to reach such conduct. The following year, Congress specifically considered including a provision in the Private Securities Litigation Reform Act (the "PSLRA") that would restore aiding and abetting liability.

Ultimately, Congress concluded that only the SEC – which, unlike private plaintiffs, does not possess a profit motive and is charged with considering the market impact of its actions – should have the right to bring claims against those who aid and abet securities fraud.[2] 15 U.S.C. § 78t(e). *See also* S. Rep. No. 104-98, at 19 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 698 ("The Committee considered testimony endorsing the result in Central Bank and testimony seeking to overturn this decision. The Committee believes

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[2] Congress did so again in 2002 when, in the wake of Enron's collapse and other cases of accounting fraud, it rejected renewed calls "to restore aiding and abetting liability for those who contribute to fraud." Hearing Before the Sub. Comm. on Banking, Hous. And Urban Affairs, 107th Cong. 1037 (2002) (quoting former Senator Metzenbaum).

that amending the [Exchange] Act to provide explicitly for private aiding and abetting liability would be contrary to S. 240's goal of reducing meritless securities litigation.").

Congress thereby left the policing of aiders and abettors to a U.S. regulatory and enforcement system that is widely regarded as the most comprehensive in the world. *See* William H. Donaldson, Chairman, SEC, U.S. Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers, London, England, Jan. 25, 2005, http:www.sec.gov/news/speech/spch012505whd.htm ("[S]ince the 1930s, the U.S. has required some of the most extensive financial disclosures, backed up by one of the most robust enforcement regimes of any jurisdiction in the world."). In so doing, Congress struck a careful balance between protecting investors and promoting a healthy and robust U.S. economy.

Plaintiffs' lawyers, displeased with Congress' judgment, sought ways to redefine as primary violators those who traditionally had been considered aiders and abettors. The *Stoneridge* case is a textbook example of this effort. As Petitioner acknowledges, Charter shareholders allegedly were deceived by misleading financial statements prepared and disseminated by Charter. They did not know about the transactions between Charter and the Respondents that are the subject of the complaint. (*E.g.*, Br. for Pet'r at 15; *see also id.* at 28 (conceding that "Respondents . . . did not themselves make misrepresentations or omissions to investors")). Respondents made no statements to Charter shareholders and owed no legal duty to do so; their only role was as counterparty to transactions that Charter allegedly mischaracterized in its financial statements.

Traditionally, such a case would be considered one of "misstatement" brought under Rule 10b-5(b). Charter would be the primary violator, and the Respondents universally would be regarded as, at most, (if proven) aiders and abettors of Charter's violation. *See, e.g., K&S P'ship v. Cont'l Bank,*

N.A., 952 F.2d 971, 976-77, 979-80 (8th Cir. 1991) (participation in business transactions challenged as "substantial assistance" in furtherance of primary violation); *Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301 (10th Cir. 1987) ("Plaintiffs also alleged that Fidelity Bank, N.A. and its president . . . aided and abetted in a conspiracy to promote the scheme by engaging in a fraudulent and deceptive transaction . . . ."); *see also Landy v. FDIC*, 486 F.2d 139, 163 (3d Cir. 1973) (addressing whether the "substantial assistance" component of aiding and abetting was satisfied where the secondary actor engaged in "a business transaction . . . which foreseeably permits one of the parties to it . . . to independently engage in illegal action"); Restatement (Second) Torts § 876(b) (1977) (defendant aids and abets when "he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself").

To avoid the *Central Bank* and PSLRA bar on private actions for aiding and abetting, Petitioner has sought to re-label the violation. Instead of pursuing a "misstatement" claim under Rule 10b-5(b), it alleges a "scheme" to make a misstatement under Rule 10b-5(a). That subsection makes it unlawful to use or employ any "device, *scheme* or artifice to defraud." (emphasis added) The argument then is that all who take part in the purported "scheme" (whether they directly deceive shareholders or not) are primary violators rather than aiders and abettors.[3]

This argument is nothing more than alchemy performed with the use of labels. Many courts confronted with this

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[3] Of course, the language of Section 10(b) itself, rather than the SEC's Rule 10b-5, defines those who can be considered primary violators. This Court has consistently held that the language of Rule 10b-5 cannot be used to expand liability beyond the scope permitted by Section 10(b) itself. *See United States v. O'Hagan*, 521 U.S. 642, 651 (1997); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472-74 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976).

tactic have correctly recognized that the "scheme" label cannot transform an aider and abettor into a primary violator. *Stoneridge Inv. Partners, LLS v. Scientific-Atlanta Inc. (In re Charter Communications, Inc. Sec. Litig.)*, 443 F.3d 987, 991-92 (8th Cir. 2006); *see also In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 476 (S.D.N.Y. 2005) (claiming defendants were part of scheme to make misstatements "would result in the circumvention of . . . Central Bank's prohibition of aider and abettor liability); *In re Dynegy Sec. Litig.*, 339 F. Supp. 2d 804, 916 (S.D. Tex. 2004) ("[P]laintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent Central Bank's limitations on liability for a secondary actor's involvement in the preparation of false and misleading statements.").

Labels aside, civil liability under Section 10(b) can and should be determined by the test established by this Court in *Central Bank*: "Any person or entity . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191.

As this Court observed in *Central Bank*, a fundamental defect in aiding and abetting liability is that it permits Section 10(b) liability where the essential elements of securities fraud have not been shown as to each defendant. Petitioner's "scheme" theory reprises *precisely* that defect.

Charter shareholders did not directly rely on Respondents' conduct, as is required under *Central Bank*. 511 U.S. at 180 (declining to permit Section 10(b) claim for aiding and abetting, as it would impose liability "without any showing that the plaintiff relied upon the aider and abettor's statements or actions.") Shareholders allegedly were deceived by, and relied on, Charter's misreporting of certain transactions, including those transactions in which Respondents participated. Charter's shareholders cannot claim that they

were deceived by the transactions themselves, because they do not claim they were even aware of Respondents' transactions with Charter.

Nor were Petitioner's losses caused by the conduct of the Respondents, as the PSLRA requires. 15 U.S.C. § 78u-4(b)(4) ("the act or omission *of the defendant* alleged to violate this title caused the loss." (emphasis added)) *See also Dura Pharm, Inc. v. Broudo*, 544 U.S. 336, 346 (2005) (rejecting recovery under section 10(b) "where these two traditional elements [of causation and loss] in fact are missing.") As Petitioner concedes, Charter's stock price was affected not by the transactions in which Respondents participated, but by the manner in which Charter reported those transactions in its publicly-filed financial statements. (*E.g.*, Br. for Pet'r at 15)

And it was Charter, not Respondents, that allegedly misreported the challenged transactions in order to inflate its stock price, thereby "use[ing] or employ[ing]" a deceptive device "in connection with the purchase or sale of any security" as the plain language of Section 10(b) requires.

For these reasons, there can be no primary liability against Respondents in this case unless the elements of a Section 10(b) claim, including reliance and loss causation, are effectively ignored. This Court was unwilling to do that in *Central Bank* and the same result should obtain here.

A finding of primary liability here would also violate another fundamental precept recognized in *Central Bank*: the securities laws should be interpreted to promote certainty and predictability because these characteristics are critical to the fair and efficient functioning of the U.S. securities markets. As the Court stated:

> As an initial matter, the rules for determining aiding and abetting liability are unclear, in "an area that demands certainty and predictability."

> Pinter v. Dahl, 486 U.S. at 652. That leads to the undesirable result of decisions "made on an ad hoc basis, offering little predictive value" to those who provide services to participants in the securities business. *Ibid.* "Such a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5" is not a "satisfactory basis for a rule of liability imposed on the conduct of business transactions." Blue Chip Stamps, 421 U.S. at 755.

511 U.S. at 188.

Indeed, the "purpose and effect" test proposed by Petitioners would inevitably lead to fact-based and subjective determinations regarding why two companies completed a transaction. The resulting *ad hoc* decisions, based on almost imperceptible distinctions, will offer little predictive value to other companies wishing to engage in business transactions with U.S. public companies.

In particular, it will be nearly impossible for parties to reliably predict the circumstances under which a court will find that parties entered into a transaction whose "principal purpose and effect" was to inflate the U.S.-listed company's financials. On what side of the line would otherwise legitimate transactions entered into for tax purposes fall? What would become of parties who participate in discounted sales or sales of assets just before year-end? Even where the transactions are legitimate sales, would the timing of the transaction just before the end of a financial reporting period suggest to a court that the transaction had the principal purpose and effect of inflating financial results? What about the thousands of legitimate securitized transactions entered into each year that follow all of the relevant legal and accounting rules, but are done to remove an asset from an issuer's balance sheet? The variations are endless and there is

little doubt that U.S. courts, as well as parties to legitimate business transactions around the world, would struggle mightily with these questions.

A test for liability that raises such questions is unacceptable. Indeed, this court's major opinions in the area of implied rights under Section 10(b) all require clear rules and well-defined contours in order to avoid market inefficiencies and litigation abuses. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975) (limiting private Section 10(b) actions to actual "purchasers or sellers," lest persons be encouraged to bring lawsuits that have "settlement value to the plaintiff out of any proportion to its prospect of success") *Ernst & Ernst,* 425 U.S. at 214 n. 33 (limiting private Section 10(b) actions to those in which defendants possess the requisite scienter, noting that failure to limit the claim in this way would "extend to new frontiers" the reach of Section 10(b) and would raise "serious policy questions not yet addressed by Congress"). *See also Virginia Bankshares* v. *Sandberg*, 501 U.S. 1083, 1110 (1991) (Scalia, J., concurring) ("I think the federal cause of action at issue here [under Rule 14a-9 of the SEC's proxy rules] was never enacted by Congress . . . and hence the more narrow we make it (within the bounds of rationality) the more faithful we are to our task."). In light of these concerns, the expansion of an implied right of action under Section 10(b) is a matter best left to Congress, and the Eighth Circuit's ruling on Section 10(b) liability should stand.

Were the Court to decide otherwise, a foreign company doing business with a U.S. public company would be forced to consider the possibility of false accounting every time it engaged in a transaction. Companies do not customarily inquire into their counterparties' accounting judgments, but even if it were practical to do so, most foreign companies apply the accounting standards of their home countries. They simply do not have (and cannot be expected to employ) sufficient expertise to evaluate the accounting treatment

proposed by a U.S. public company, which would have to be in accordance with U.S. Generally Accepted Accounting Principles ("GAAP").

In the end, Petitioner's version of "scheme" liability will inject into the United States's carefully considered securities law enforcement system an unpredictable and potentially arbitrary mechanism for determining liability. And that mechanism would be placed in the hands of the class action bar, not the SEC. That combination creates precisely the litigation risk that discourages foreign companies from doing business in the United States. Commentary, *Down on the Street*, ECONOMIST, Nov. 23, 2006 (*available at* http://www.economist.com/business/displaystory.cfm?story_id=8316406) ("Many businessmen regard America's legal system, with its punitive jail terms and class-action lotteries, even less favourably than they view Sarbanes-Oxley.").

II. PETITIONERS' PROPOSED "SCHEME LIABILITY" WILL DETER FOREIGN COMPANIES FROM DOING BUSINESS WITH U.S. COMPANIES

There is a widely acknowledged perception, backed by empirical evidence, that a hostile U.S. litigation environment materially increases the costs and risks associated with raising capital in the U.S. markets. Several recent studies demonstrate that this environment is a driving force behind the precipitous decline in U.S. capital market activity.

The introduction of scheme liability to the legal landscape could have a similar impact on the level of general commercial activity between foreign companies and U.S. public companies. This is so because scheme liability not only exposes those who engage in commercial transactions with U.S. issuers to liability for the issuer's misrepresentations, but also increases the likelihood that the silent counterparty could be held liable for scheme-wide

damages far in excess of those that can be traced to the counterparty's conduct.

This fact is powerfully illustrated in the *Stoneridge* case. Here, although Respondents participated in transactions representing less than 4% of the artificial inflation alleged, the Petitioners seek to hold Respondents liable for all alleged shareholder losses – approximately $7 billion.

As this Court has previously recognized, these kinds of outsized damages claims almost inevitably result in huge settlements, regardless of the substantive merits of the case. *See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 80-81 (2006) (citing *Blue Chip Stamps v. Manor Drug Stores* for the proposition that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.")

Confronted with such unpalatable realities, counterparties both foreign and domestic will either decline to engage in transactions with U.S. issuers or will do so only after engaging in a *de facto* audit of their counterparties' intended accounting and reporting. Foreign companies, in particular, are ill-suited to this gatekeeper role. The legal structures in the world's other major financial centers vigorously protect their investors and their markets, but do not impose such illogical burdens. And there is no reason to believe that the U.S. Congress, when it refused to restore a private right of action for aiding and abetting under Section 10(b), intended the United States to be an exception among its peers.

A. Recent Studies Indicate that Foreign Companies Will Be Deterred from Engaging in Business Transactions with U.S. Public Companies

In the past year, three separate, highly publicized reports[4] analyzed the precipitous decline in the competitiveness of U.S. capital markets and the rise of alternative markets and exchanges in countries around the world, most notably in the United Kingdom.[5] All three reports concluded that one critical cause of the decline in U.S. competitiveness is foreign companies' fears of being drawn into shareholder lawsuits.

The sanctioning of scheme liability would greatly exacerbate the concerns of the international business community, as it would directly target not just companies that deliberately choose to list themselves on the U.S. exchanges,

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[4] U.S. Chamber of Commerce, *Commission on the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations* (Mar. 2007) (*available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.htm); Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and US' Global Financial Services Leadership* (Jan. 22, 2007) (*available at* http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf); Committee on Capital Markets, *Interim Report of the Committee on Capital Markets Regulation* (Nov. 30, 2006) (*available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf).

[5] The statistics are compelling. In 2000, 50% of dollars raised by international companies outside of their home markets were raised on a U.S. exchange. *Interim Report of the Committee on Capital Markets Regulation*, at 2. By 2005, only 5% of these dollars were raised on a U.S. exchange, with 24 of the 25 largest IPOs completed in markets outside the United States. Senate Republican Policy Committee, *Excesses Threaten U.S. Competitiveness, When Excess Damages Success: Have Litigation, Taxation, and Regulation Gone Too Far*, June 19, 2007, at 2. In 2006, that was the case for 23 of the 25 largest IPOs. Id.

but any and all counterparties to general commercial transactions with U.S.-listed companies. Consequently, the hostile litigation environment that has discouraged foreign companies from raising capital in the U.S. markets would, with the addition of scheme liability, undoubtedly have a similarly chilling effect on the willingness of foreign companies to conduct a wide range of commercial transactions with U.S. issuers.

Indeed, the report commissioned by New York City Mayor Michael Bloomberg and Senator Charles Schumer ("Bloomberg/Schumer Report") has found that the threat of securities litigation already is proving a deterrent to foreign companies that wish to "do business in the United States." *Bloomberg/Schumer Report*, at 101. A closer examination of the report suggests that scheme liability would greatly exacerbate these concerns.

In attempting to understand what drives U.S. competitiveness, McKinsey & Company, on behalf of Mayor Bloomberg and Senator Schumer, personally interviewed more than 50 financial industry CEOs and business leaders, received surveys from an additional 30 financial services CEOs in the United States, and separately polled 275 additional global financial services senior executives. *Id.* at 8. McKinsey also interviewed representatives of investor, labor and consumer groups and interviewed and worked with leaders and subject matter experts in the regulatory, legal and accounting professions. *Id.* Through these interviews and surveys, McKinsey identified several factors that dominated the survey participants' views of the business environment in New York, and by extension, the United States.

"[A] fair and predictable legal environment" was among the most important factors considered (ranked behind only the skill of the labor force), and in this regard the United States is commonly perceived to be at a significant disadvantage. *Id.* Indeed, not a single survey participant believed that the legal

environment of the United States presented an advantage over its primary competitors. *Id.* at 75.

Two perceptions figure into this assessment. First, the United States is viewed as overly litigious. Unfortunately, the facts support the perception. Some estimates put the cost of the U.S. tort system in 2004 at $260 billion, which is double 1990 levels. *Id.* at 74. Perhaps more troubling, the growth rate of these costs has accelerated in recent years. Whereas tort system costs grew at 3 percent per year between 1990 and 2000, the growth rate reached 10 percent annually from 2000 to 2004. *Id.*

Securities lawsuits drive a meaningful portion of these costs. One recent study concluded that the average public company has nearly a 10 percent probability of facing at least one shareholder class action lawsuit over the course of a five-year period. *Interim Report of the Committee on Capital Markets Regulation*, at 74 (citation omitted). Foreign companies are acutely aware of these odds. In 2003, for example, China's largest insurance company, China Life, listed on the New York Stock Exchange. Financial Times, Nov. 18, 2005, p. 17. Within three months, the company was the subject of civil lawsuits and an SEC investigation over the accuracy of its pre-IPO disclosures. *Id.* China Life's experience served as a cautionary tale to other foreign companies, and is widely viewed as having driven many Asian companies from the U.S. capital markets. *See, e.g., Hong Kong poses threat to New York as global financial service leader*, Euromoney Institutional Investor, Nov. 1, 2006, p. 49.

These securities suits are not only frequent, but also ever more costly. The total bill for settlements of securities-related lawsuits in 2005 was $3.5 billion – $9.8 billion if the WorldCom settlement is included. *Bloomberg/Schumer Report* at 74. This amount was more than 15 percent higher than in 2004, and 70 percent higher than in 2003. *Id.* By

2006, the average settlement in securities-related litigation was $62.3 million, an astonishing 45 percent increase over the $27.8 million average settlement in 2004. *Id.* at 75. Foreign issuers have not been spared from this trend, as the total settlement value of private securities claims brought against foreign issuers almost tripled from $495 million in 2003 to $1.35 billion in 2005. In 2006, this amount further increased to $2.4 billion.[6] PricewaterhouseCoopers 2006 Securities Litigation Study at 62 (*available at* http://www.pwc.com/extweb/pwcpublications.nsf/docid/a89d7b2aa156e4f1852572ce005bbd54).

Scheme liability would increase both the frequency and cost of securities litigation. First, the theory of scheme liability was created specifically to draw in deep-pocketed secondary actors where the primary actors (for example, the bankrupt issuer and its officers and directors) cannot satisfy the anticipated judgment. Second, almost every scheme liability case involves an allegation that the secondary actor engaged in "knowing" conduct and, under the PSLRA, is jointly and severally liable not only for its own conduct, but also for the conduct of all other "schemers," even where the secondary actor did not participate in or even know about others' conduct. The prospect of joint and several liability for others' conduct greatly enhances the pressure on a secondary actor defendant and, in turn, the likelihood and magnitude of a settlement.

The second perception impacting the assessment of the U.S. legal environment relates to its perceived fairness and predictability. Only 15 percent of CEOs surveyed in the Bloomberg/Schumer Report felt that the U.S. system was more predictable and fairer than that of other countries.

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[6] The increase in total settlement value for foreign issuers in 2006 is attributable primarily to two settlements entered into by Nortel Networks, which totaled $2.2 billion.

Indeed, many corporations now choose English law to govern their international commercial contracts, rather than the law of the United States, precisely because they view English law as more predictable. *Id.* at 77.

As discussed above, the contours of scheme liability are particularly ill-defined and therefore would create a materially more uncertain environment for foreign companies wishing to do business with U.S. public companies. The United States possesses the strongest criminal and regulatory enforcement regime in the world.[7] This regime acts as a powerful deterrent to wrongful aiding and abetting conduct. Petitioner's scheme liability theory would represent a step back from the strong regulatory enforcement regime designed by Congress and a step toward the unpredictable liabilities and coercive settlements that go hand in hand with private securities litigation.

B. Commentators at Home and Abroad Agree that Petitioners' Approach to "Scheme Liability" Would Deter Foreign Companies from Engaging in Transactions with U.S. Companies

Senior U.S. government officials, as well as foreign and domestic commentators, recognize that the scheme liability rule proposed by Petitioners could have a chilling effect on significant aspects of the U.S. economy. In testimony before the House Committee on Financial Services, U.S. Treasury Secretary Henry M. Paulson observed:

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[7] Just as the SEC has authority to pursue aiders and abettors, so too does the Department of Justice, which has parallel enforcement jurisdiction under the Securities Exchange Act of 1934 (15 U.S.C. § 78u (h)(9)(B)), as well as 18 U.S.C. § 2.

> The principle [at stake in the *Stoneridge* case] that is important to me is in terms of competitiveness and is important to people on both sides of the aisle. When Senator Schumer and Mayor Bloomberg did a study and looked at our capital markets and the impact on our economy, what did they cite? Excessive litigation risk as a big issue.... And so my concern here is by exposing all sorts of third parties that happen to do business with a public company to primary liability, exposing third parties to that primary liability without clear lines is a risk to our economy, to our competitiveness, to jobs.

The State of the International Financial System: Hearing Before the H. Comm. on Financial Services (2007) (Testimony of Henry Paulson) (*available at* http://financialserv.edgeboss.net/wmedia/financialserv/hearing062007.wvx); *see also* Stephen Labaton, *Investors' Suits Face Higher Bar, Justices Rule*, N.Y. TIMES, June 22, 2007, at A1. C. Boyden Gray, the U.S. ambassador to the European Union, summarized these risks: "If there's a choice between doing business with a company that is listed in New York or one that is not, you would go with the one that was not. It's just not healthy for the transatlantic investment climate." Tim Shipman, *Stoneridge Court Case Threatens Trade with U.S.*, SUNDAY TELEGRAPH, July 7, 2007 (*available at* http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2007/07/08/wlitig108.xml).

Former U.S. Attorney General Dick Thornburgh, who served as court-appointed Examiner in the WorldCom bankruptcy cases, also acknowledged the "dangerous 'ripple effects' if businesses were discouraged from dealing with public companies because they might be sued as 'aiders and abettors' of someone else's fraud." Dick Thornburgh, Commentary, *Class Action Gamesmanship*, WASH. TIMES,

June 15, 2007, at A14. He recognized that unless these lawsuits can be dismissed before trial, they will lead to "exorbitant settlements that have little or no relation to each defendant's legal liability" since most counterparty defendants will decide that the risks and costs associated with litigating the scheme case are simply too high. *Id.*

He further endorsed Congress' decision to leave the policing of aiders and abettors to the Justice Department and the SEC, rather than to class action lawyers who "game the legal system to extort exorbitant settlements from business and professionals who deal with a public company that goes under." Id.

Other commentators have echoed this view. *See, e.g., The Stoneridge Showdown*, ECONOMIST, June 16, 2007 (*available at* http://www.economist.com/finance/displaystory.cfm?story_id=9340553) ("An unfavorable ruling [in this case] would send a chill through boardrooms, and not only in America...[because] it would no longer even be necessary to issue shares in the United States to incur securities liability...Any firm, anywhere, doing business with American companies would have to live with the risk that the transaction could later be portrayed as fraudulent or deceptive. And painting such pictures is what trial lawyers do best.").

Commentators abroad are particularly interested in this case, viewing it as a bellwether of the litigation environment in the U.S. In the respected German newspaper *Boersenzeitung*, editors noted that to avoid the risks associated with Appellant's approach to scheme liability, "businesses dealing with listed companies in the U.S. would have to examine the possibility of a false booking in every transaction, which is practically impossible. This would put into question basic elements of doing business, such as legal certainty and forseeability." Editorial, *Transatlantische*

Beziehungen in Gefahr [*Transatlantic Relations in Danger*], BOERSENZEITUNG, June 28, 2007, at 14.

The editors also observed that "transatlantic business relations would be burdened by significant additional costs stemming from misunderstood investor protection" and that adoption of scheme liability would be perceived to be at odds with the spirit of the April 2007 U.S.-E.U. Economic Summit at which the parties agreed to work towards the "harmonization of . . . the regulatory environment for capital and financial markets." *Id.* The editors concluded that scheme liability therefore poses a "danger of dramatic damage to the transatlantic economic relations." *Id.*

These concerns were echoed in an article in the leading German business daily newspaper *Handelsblatt*, which suggested that foreign companies will be specifically targeted in scheme liability lawsuits due to their unfamiliarity with U.S. law. *A Wave of U.S. Class Actions Threatened*, HANDELSBLATT, Aug. 1, 2007, at 19. A Freshfields Bruckhaus Deringer lawyer quoted in the article insisted that "[o]ne would need to advise clients to meticulously check whether payments made to the US business partner are being reported correctly by the business partner" and that the scheme theory would "introduce a standard of care which would be impossible to satisfy." *Id.*

Indeed, several senior executives of foreign corporations recently emphasized that the cost and risk of litigation is a substantial barrier to doing business in the United States, explaining that "litigation is a greater disincentive to doing business in the U.S. than fears that a protectionist Congress might impose new barriers to foreign trade and investment." Ian Swanson, *Foreign Executives Press for Reform of Litigation in United States,* THE HILL, May 18, 2007, at 11.

C. Foreign Countries Do Not Follow the Approach to Scheme Liability Advocated by Petitioners

The failure to adopt scheme liability would not signal laxness on the part of the United States. To the contrary, the laws of the world's other major financial centers do not provide for the counterparty liability proposed by Petitioners here. These jurisdictions have established systems that comprehensively safeguard investor rights without resort to the unpredictable and unprincipled civil exposure at issue in this case.

As set forth below, these countries have established clear lines for civil liability under their securities laws. Generally, they do so typically by explicitly identifying categories of persons or entities that can be sued in the event of a misstatement. In a case involving a commercial transaction where a counterparty misreports the transaction in its financial statements, generally only the misrepresenting issuer, along with the responsible officers, directors and auditors, can be liable. Silent counterparties are not liable for the misstatements of the issuer.

1. United Kingdom

The Financial Services and Markets Act of 2000 ("FSMA") is the main piece of legislation governing financial services in the United Kingdom. The FSMA contains provisions akin to Section 10(b) that impose civil liability for untrue or misleading statements made in offering documents, publicly disclosed financial reports or statements, and other documents that an issuer must make publicly available. Section 90, FSMA.

Under these provisions, issuers, as well as directors or other persons discharging managerial responsibilities in relation to such issuers, may be liable for any false or misleading

statements contained in these documents. Section 90, FSMA. Liability is not imposed by statute or regulation on third parties that enter into transactions with the issuer which the issuer then misreports.

2. Canada

Securities regulation in Canada is a matter of provincial law. There are minor differences between the various provincial regulatory schemes. However, Ontario is Canada's business capital and home to the Toronto Stock Exchange. Thus, the overwhelming majority of corporations subject to Canadian securities law are subject to Ontario's *Securities Act* (the "Act").

In connection with "primary market misrepresentations" – statements made in prospectuses, offering memoranda and take-over circulars – only the issuer, the underwriters, the directors of the issuer, those who signed the prospectus or circular, and those "whose consent to disclosure of information in the prospectus has been filed pursuant to a requirement of the regulations," can be held civilly liable under the Act.[8] R.S.O. 1990, c. S.5 ss. 130, 130.1 and 131. There is no provision that would hold any third-party (including counterparty to a misreported transaction) civilly liable for the misrepresentation.

The Act also provides for liability in the context of misrepresentations made in other "secondary market" materials, such as annual or quarterly fillings and certain press releases. Like the primary market regime, the secondary market regime is limited to certain actors: the issuer; in the case of a misrepresentation in an oral statement, the person who made the statement; every director of the

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[8] In the case of an offering memorandum, there only exists a cause of action against the issuer. In the case of a take-over circular the persons liable are the same as in the case of a prospectus, with the offeror stepping into the role of the issuer. *Id.* at § 131.

issuer; every officer of the issuer, if they "authorized, permitted or acquiesced" to the misrepresentation or failure to disclose; every influential person who knowingly influenced the misrepresentation or failure to disclose, where an influential person is, essentially, a person with control over the issuer, an insider or, if the issuer is a mutual fund, a fund manager; and experts (accountants, auditors, lawyers and the such) where the misrepresentation made is included in their report, that report is included or summarized in a document containing misrepresentations, and the expert consented, in writing, to the use of the report. R.S.O. 1990, c. S. 5 s. 138.3.

As with the primary market liability scheme, there is no provision in the Act to hold any other party liable for another's secondary market violations.

3. Germany

The German Securities Trading Act (the "WpHG") contains the principal statutory provisions governing capital markets activity in Germany. Similar to their counterparts in the UK and Canada, these provisions limit liability for misstatements to the issuer and, potentially, certain directors and officers of the issuer. WpHG, Section 37(b), (c). They do not provide for claims against silent third-parties to commercial transactions that the issuer misreports.

CONCLUSION

The decision of the court of appeals should be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, COURT-APPOINTED LEAD PLAINTIFF IN THE *ENRON SECURITIES LITIGATION*, AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Does liability exist under §10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5, where an actor knowingly uses or employs deceptive devices and contrivances as part of a scheme to defraud investors in another public company, but itself makes no affirmative misrepresentations to the market?

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INTEREST OF *AMICUS CURIAE*

The Regents of the University of California ("The Regents"), which suffered losses exceeding $140 million in connection with the notorious Enron fraud, appears in this matter in its capacity as the court-appointed Lead Plaintiff authorized under 15 U.S.C. §78u-4(a)(3) to act in connection with the *Enron* securities litigation on behalf of a class of all persons who purchased the publicly traded securities of Enron Corporation between October 19, 1998, and November 27, 2001. *See In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427 (S.D. Tex. 2002).[1]

With a mission of teaching, research, and public service, the University of California is the nation's premier research university, and The Regents is the instrumentality of the state, "fully empowered in respect of the organization and government of the university, which, as it has been held, is a constitutional department or function of the state government."[2]

With 10 campuses, more than 201,000 students, and better than 160,000 employees, the University is governed by its 26-member Board of Regents. Pursuant to its constitutional authority, The Regents serves as a fiduciary for the University's pension and endowment funds, overseeing more than $50 billion invested in publicly traded U.S. securities.

The Regents accordingly has a strong interest in enforcement of our nation's securities laws — to ensure the transpar-

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[1] This *amicus* brief is filed with all parties' consent. No counsel for any party to this matter authored this brief or any portion of it, and no party has made any monetary contribution to the preparation or submission of this brief. As noted in text, The Regents is court-appointed Lead Plaintiff in the *Enron* securities litigation. The Regents or its counsel may ultimately seek compensation in that case for the work and expenses incurred in preparing this brief.

[2] *Hamilton v. Regents of the Univ. of Cal.*, 293 U.S. 245, 257 (1934); *see* Cal. Const. art. IX, §9; *Ishimatsu v. Regents of Univ. of Cal.*, 266 Cal. App. 2d 854, 864, 72 Cal. Rptr. 756, 763 (1968). Citations and footnotes are omitted and emphasis is added unless otherwise noted.

ency and integrity of the securities markets, and that victims of fraud are compensated. In February 2002, moreover, The Regents was appointed by the United States District Court for the Southern District of Texas to serve as Lead Plaintiff for a class of investors who purchased Enron securities. *See Enron*, 206 F.R.D. at 454-59. In that capacity The Regents is prosecuting claims against many defendants who, acting together, hid Enron's debt and fabricated Enron's financial results — thereby defrauding many thousands of investors out of billions of dollars. Many lost their life savings. The Regents suffered more than $140 million in losses due to fraud in connection with its purchases of Enron securities.

Featuring a complex scheme perpetrated by many participants and over many years, the Enron fraud is emblematic of the recent wave of corporate scandals that has shaken confidence in U.S. securities markets. *See In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 613-85, 692-707 (S.D. Tex. 2002).[3] Denying motions to dismiss, the district court in *Enron* held that The Regents was entitled to proceed under §10(b) against entities, including Merrill Lynch and Credit Suisse, who designed and implemented deceptive financial transactions in order to hide Enron's debt and inflate Enron's reported financial results, because they had actively engaged in a scheme to defraud investors by executing their deceptive devices and contrivances. *See, e.g., In re Enron Corp. Sec. Litig.*, 310 F. Supp. 2d 819, 827-30 (S.D. Tex. 2004);[4] *Enron*, 235 F. Supp. 2d at 581-94, 613-707.

The district court then certified a class, holding again that §10(b)'s proscription of "deceptive" devices is broad enough to cover Enron's bankers' central role in "'transaction[s]

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[3] The quoted opinion is reproduced in the Appendix to the *Enron* Petition for Certioriari, captioned *The Regents of the Univ. of Cal. v. Merrill Lynch Pierce Fenner & Smith*, No. 06-1341, at 407a-678a cited hereafter as "*Enron* Pet. Appx."

[4] *Enron* Pet. Appx. at 329a-406a.

whose principal purpose and effect is to create a false appearance of revenues.'" *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *167 (S.D. Tex. June 5, 2006) (first class-certification opinion and order)[5]; *see also In re Enron Corp. Sec. Litig.*, 236 F.R.D. 313 (S.D. Tex. 2006) (second class-certification opinion and order).[6] Judge Harmon's opinion specifically tracked the SEC's position that under §10(b) and Rule 10b-5 "a 'deceptive act' includes a 'transaction whose principal purpose and effect is to create a false appearance of revenues,' which can be accomplished by acts as well as by words." *Enron*, 2006 U.S. Dist. LEXIS 43146, at *167. The *Enron* district court found persuasive the SEC's distinctions between deceptive acts, on the one hand, and aiding and abetting, on the other, and expressly adopted the SEC's approach to certify a class. *Id.* at *173. The SEC itself had explained, in an *amicus curiae* brief before the Ninth Circuit, that:

> "[D]eceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by actions as well as words. For example, if an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding the company debt, it has achieved the same deception, and liability should be equally available."

Enron, 2006 U.S. Dist. LEXIS 43146, at *165 (quoting SEC *amicus curiae* brief from *Simpson v. AOL Time Warner*, 452 F.3d 1040 (9th Cir. 2006), *petition for cert. filed*, (Oct. 19, 2006) (No. 06-560)).[7]

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[5] *Enron* Pet. Appx. at 58a-296a.

[6] *Enron* Pet. Appx. at 297a-310a.

[7] The Brief of The SEC as *Amicus Curiae*, in *Simpson v. Homestore, Inc.*, No. 04-55665 (9th Cir. Oct. 22, 2004), is available at www.sec.gov/litigation/briefs/homestore192194.pdf.

Enron's bankers, who had devised and executed the sham transactions that hid Enron's debt and that generated its phony financial results, obtained leave from the Fifth Circuit to take an interlocutory appeal. *See Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372 (5th Cir. 2007) ("*Enron*"). Recognizing that The Regents stated valid claims under the test formulated by the SEC, and adopted by the Ninth Circuit in *Simpson*, 452 F.3d 1040, the Fifth Circuit nonetheless reversed — ruling that the claims failed under the Eighth Circuit's competing standard stated in *In re Charter Commc'ns., Inc.*, 443 F.3d 987 (8th Cir. 2006), the decision presently under review.

The *Enron* panel majority wrote that "the Eighth and Ninth Circuits have split with respect to the scope of primary liability for secondary actors" who engage in conduct designed to mislead investors. *Enron*, 482 F.3d at 386. The panel majority acknowledged: "The district court adopts a rule advocated by the Securities and Exchange Commission ('SEC') . . . under which primary liability attaches to anyone who engages in a 'transaction whose principal purpose and effect is to create a false appearance of revenues.'" *Id.* But the Fifth Circuit rejected that test: "We agree with the Eighth Circuit that the SEC's proposed test . . . is too broad to fit within the contours of §10(b)." *Id.* at 386-87. "The Eighth Circuit, unlike the Ninth," the Fifth Circuit majority explained, has taken this Court's "decisions collectively to mean that '"deceptive" conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose.'" *Id.* at 388 (quoting *Charter*, 443 F.3d at 990). Thus, though Enron, as an issuer of securities, was under a duty to issue truthful financial statements, the Fifth Circuit held that its bankers were free to engage in whatever deceptive practices they pleased — so long as they *said* nothing about it. *See id.*

The Regents' petition for certiorari in that case, in which the Fifth Circuit followed the decision below in this proceeding to terminate the *Enron* class action, *see Enron*, 482 F.3d

at 386-88, currently is pending before this Court as *The Regents of the Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 06-1341, *petition for cert. filed* (Apr. 5, 2007).

The decision in this case is apt to be critical to claims of The Regents and other victims of the Enron fraud. The Regents as Lead Plaintiff in the *Enron* litigation, and the class of investors that it was appointed to represent, obviously have a strong interest in ensuring that this Court adequately considers the implications of its decision in this case for other cases that — like *Enron* — involve complex fraud schemes. Moreover, the facts in *Enron* show that a clear line can be drawn between aiding-and-abetting liability and primary liability based on deliberately deceptive conduct designed to mislead investors.

THE ENRON FRAUD

The Regents' *Enron* class action arises out of the worst securities fraud in recent history, and demonstrates the difference between conduct that merely aids or abets another's wrongdoing, and conduct that is itself deliberately deceptive.

Thousands of investors lost billions of dollars in an acknowledged fraud that produced many criminal and regulatory proceedings, investigations, and hearings, all documenting massive financial wrongdoing. But Enron's bankruptcy, the collapse of its accountants, limited insurance, and government seizure of key insiders' assets, all appeared to doom the victimized investors to a minimal recovery in their §10(b)/Rule 10b-5 civil class-action suit — except for claims the investors asserted against certain large banks (the "Banks"), which had used deceptive devices and contrivances to hide Enron's debt and fabricate phony financial results in a deliberate scheme to defraud Enron investors.

The Regents alleged the Banks reaped huge profits by engaging in the scheme in which they:

- structured contrived financial transactions to falsify Enron's financial statements (generating fake profits and hiding billions of dollars of debt);
- sold billions in new Enron securities to the public (via prospectuses and circulars containing the falsified financial statements), thereby raising the fresh funds required to keep the Enron Ponzi scheme going; and
- had their securities analysts recommend Enron's stock via false analyst reports. This conduct inflated Enron's securities until the truth came out during 2001, causing the securities' prices to plummet and become worthless.[8]

The *Enron* district court, relying on The Regents' complaint and on briefs submitted by the SEC, upheld the factual adequacy and legal sufficiency of allegations that the Banks violated §10(b) by engaging in the fraudulent scheme.[9] Over the next five years, the district court refined its rulings regarding scheme liability to "tighten" the standard and require that each bank used a deceptive act or contrivance — reflecting new decisions,[10] and an SEC *amicus curiae* filing in

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[8] *See Enron*, 235 F. Supp. 2d at 613-14, 631, 633-37 (noting The Regents' allegation that "[i]n 2001, matters at Enron began to fall apart" and describing events leading to Enron's December 2, 2001, bankruptcy); *Enron*, 310 F. Supp. 2d at 827, 832, 836 (same). The Regents' pension fund, containing retirement savings of nearly 500,000 present and former employees of the University of California system, lost more than $140 million in the collapse of Enron's stock. *See Enron*, 206 F.R.D. at 454.

[9] The pleading satisfied all of the falsity and scienter pleading requirements imposed by both Fed. R. Civ. P. 9(b) and the 1934 Act §21D(b), 15 U.S.C. §78u-4(b), as to Merrill Lynch and Credit Suisse. *See Enron*, 310 F. Supp. 2d at 827-30; *Enron*, 235 F. Supp. 2d at 613-707.

[10] The district court relied on Judge Kaplan's extensive discussion of the relevant law in *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 504 (S.D.N.Y. 2005):

> The defendants' argument that they were at most aiders and abettors of a program pursuant to which Parmalat made misrepresentations on its financial statements misses the mark. The transactions in

Simpson, 452 F.3d 1040, supporting scheme liability. The district court ultimately adopted the SEC's test for scheme liability.[11]

The Regents' counsel analyzed millions of documents and took hundreds of depositions, and Enron's court-appointed Bankruptcy Examiners' investigations detailed the Banks' "knowing participation" in the fraud.[12] In 2006, certain banks settled the fraud claims against them for $6.6 billion, stipulating to a settlement class.[13]

> which the defendants engaged were by nature deceptive. They depended on a fiction, namely that the invoices had value. It is impossible to separate the deceptive nature of the transactions from the deception actually practiced upon Parmalat's investors. Neither the statute nor the rule requires such a distinction.

[11] *Enron*, 2006 U.S. Dist. LEXIS 43146, at *165-*173. Accordingly, in order for scheme liability to exist, the district court required that the defendant *commit a deceptive act*. For example:

> Lead Plaintiff must allege specific details that show that a structure of the entity or a transaction that was created by Barclays was inherently deceptive *and that Barclays used and employed it to deceive investors,* not that Enron, its officers and accountants subsequently used the entity improperly to cook its books, or that Barclays engaged in acts, practices, or a course of business that operated as a fraud or deceit upon any person in connection with the purchase or sale of an Enron security.

In re Enron Corp. Sec. Litig., No. H-01-3624, 2006 U.S. Dist. LEXIS 88121, at *21-*22 (S.D. Tex. Dec. 4, 2006).

[12] Third Interim Report of Neal Batson, court-Appointed Examiner at 82 ("Merrill Lynch had actual knowledge of the wrongful conduct in these transactions . . . ."); Final Report of Neal Batson, court-Appointed Examiner at 75 ("CSFB had actual knowledge of the wrongful conduct in these transactions . . . ."); Third Interim Report of Neal Batson, Court-Appointed Examiner at 66 ("Barclays had actual knowledge of the wrongful conduct in these transactions . . . .").

[13] The settlements were: Citibank — $2.0 billion, J.P. Morgan Chase — $2.2 billion, and CIBC — $2.4 billion. Other settlements brought the total to $7.3 billion. The total damages exceed $40 billion.

In July 2006, after considering expert testimony and with the benefit of a well-developed evidentiary record, the district court certified for trial a class of purchasers of Enron's publicly traded securities. *Enron*, 2006 U.S. Dist. LEXIS 43146; *Enron*, 236 F.R.D. 313. With trial scheduled for April 16, 2007, however, the Fifth Circuit accepted the remaining Banks' Rule 23(f) appeal challenging class certification on the ground that they could not be liable under §10(b). *Enron* Cert. Pet. Appx. at 679a-680a. Then, less than 30 days before trial, a fractured Fifth Circuit panel reversed. *See Enron*, 482 F.2d 372.

Two judges ruled, over vigorous objections from Judge James L. Dennis (*see id.* at 394-407), that (i) the Banks could not be liable under §10(b)/Rule 10b-5 for engaging in a scheme to defraud Enron's shareholders because they made no false statements; thus (ii) no class-wide presumption of reliance under *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), was available; and therefore (iii) no class may be certified. *Enron*, 482 F.3d at 385-94. The majority acknowledged that its decision directly conflicted both with the Ninth Circuit's decision in *Simpson*, 452 F.3d 1040, and with the SEC's position.[14]

The *Enron* majority acknowledged this Court's admonition in *Central Bank* that "[t]he absence of §10(b) aiding and abetting liability *does not mean that secondary actors in the securities markets are always free from liability under the securities Acts.*" *Central Bank N.A. v. First Interstate Bank N.A.*, 511 U.S. 164, 191 (1994); *see Enron*, 482 F.3d at 386. But the lower courts had generated a Circuit "split" on the "the scope of primary liability for secondary actors" (*id.* at 386), with the Ninth Circuit holding in *Simpson*, 452 F.3d at 1048, that a defendant may be "liable as a primary violator of §10(b)

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[14] *Enron*, 482 F.3d at 385-90. The majority also implicitly rejected the views of the Attorneys General of 30 states who had filed an *amicus curiae* brief supporting scheme liability. *See Amicus Curiae* Brief of the State Attorneys General, filed in *Enron*.

for participation in a 'scheme to defraud,'" if it "engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme," while the Eighth Circuit held in *Charter*, 443 F.3d at 992, that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under §10(b) or any subpart of Rule 10b-5."

The SEC's position was that §10(b)'s text prohibits, "within the rubric of engaging in a deceptive act, engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues," drawing a clear distinction between primary and secondary liability: "Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor."[15]

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[15] Brief of the SEC as *Amicus Curiae* in *Simpson, supra* n.7, at 16-18; *see Simpson*, 452 F.3d at 1048. Deference is due the SEC's interpretation. *See SEC v. Zandford*, 535 U.S. 813, 819-20 (2002); *Nat'l Cable & Telecommc'ns. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 980 (2005); *Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837, 844 (1984); *Auer v. Robbins*, 519 U.S. 452, 462-63 (1997). As the district court explained in *Enron*, 2006 U.S. Dist. LEXIS 43146, at *165, quoting the SEC *Amicus Curiae* brief:

> "[D]eceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words. For example, if an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding the company debt, it has achieved the same deception, and liability should be equally available."

Acknowledging the SEC's view supports scheme liability, so that primary liability attaches to anyone who engages in a "'*transaction whose principal purpose and effect is to create a false appearance of revenues*,'" *Enron*, 482 F.3d at 386, the *Enron* majority nevertheless concluded "[w]e agree with the Eighth Circuit that the SEC's proposed test . . . is too broad to fit within the contours of §10(b)." *Id.* at 386-87.

"Presuming plaintiffs' allegations to be true,"[16] the *Enron* majority acknowledged The Regents had alleged: (i) that the Banks entered into "transactions that allowed Enron . . . to take liabilities off its books temporarily and to book revenue from the transactions when it was actually incurring debt [and] . . . these transactions . . . allowed Enron to misstate its financial condition" — which "gave a misleading impression of the value of Enron securities that were already on the market"; (ii) "that the banks knew exactly why Enron was engaging in seemingly irrational transactions";[17] and (iii) that the "banks intended to profit by helping the [Enron] executives maintain [the] illusion" of revenues — "inflating their stock price" — all the while knowing that "Enron was engaged in a long-term scheme to defraud investors . . . by inflating revenue and disguising risk and liability through its . . . transactions with the banks." *Enron*, 482 F.3d at 377.

The Banks' conduct was inherently deceptive. They structured and engaged in non-arm's-length transactions with Enron involving sham entities. These transactions, including fake commodity and energy trades, had no actual business purpose, but rather were designed solely to get cash to Enron while disguising loans to conceal Enron's debt, or to create fictitious operating revenues or earnings. These were "financial statement" transactions, *i.e.*, "structured finance" deals, intended to directly distort Enron's financial statements, not ordinary

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[16] *Enron*, 482 F.3d at 386.

[17] *Enron*, 482 F.3d at 376-77, 391.

arm's-length commercial transactions later misaccounted for by Enron. The Banks' documents admit the deals were designed to "*raise disguised debt*" and provide "*off-balance sheet parking lots*" for distressed assets, that the Banks had received *secret oral guarantees*, that the Banks "*will be taken out*" or the deal will "*unwind*," and that the contrived transactions were "*servicing*" Enron's "*particular accounting needs*," which "*had great value in their stock price.*"[18]

Enron's former CFO Andrew Fastow, after admitting his crimes, testified and laid it out. He said "[i]n many instances, the banks primarily *devised the financial structures.*" "In many cases, *the banks brought us these structures*, and we executed the transactions with the banks." 8R:36721 (Fastow Decl., ¶6); COR01758-59 (Fastow Depo.). They "worked together, intentionally and knowingly, *to engage in transactions that would affect Enron's financial statements.*" 8R:36722 (Fastow Decl., ¶7). According to Fastow:

> When you boil it all down, Enron wanted to paint a picture of itself to the outside world that was different from the reality inside Enron. *And these structured financial transactions, along with other things that Enron did, created that deception.*

COR01788 (Fastow Depo.); *see also* COR01756-58 (Fastow Depo.). Fastow elaborated:

> Well, Enron had a problem in that its — the results it would otherwise have published from just its business operations were usually insufficient in order for Enron to

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[18] COR01177 (Ex. 50028); COR01078 (Ex. 11664); COR00020 (ML Summary Judgment Ex. 5). Documents cited herein appear in the Record of Appeal ("R") before the Fifth Circuit in the *Regents v. Credit Suisse First Boston*, No. 06-20856, and are cited by giving the volume and the Fifth Circuit page number, *e.g.*, "8R:36721." In addition, documents cited as "COR" refer to documents submitted and attached to Appellees' Motion to Correct Omissions from the Transmitted Record also filed in *Regents v. Credit Suisse First Boston*, No. 06-20856 (5th Cir.).

> maintain its investment grade credit rating or to meet its earnings targets.
>
> And we were looking [*sic*] with banks who could help us solve this problem, meaning doing transactions that would, as we described it internally, *fill the gap between what was really happening inside Enron and what — the way we wanted Enron to appear to the outside world.*

COR01754 (Fastow Depo.). These contrivances and subterfuges reportedly deceived Enron's auditors, who testified that had they not been misled by the Banks, they would not have approved accounting for numerous transactions or provided audit certifications.[19]

But the *Enron* majority concluded that, *even assuming this was all true*, "the banks only aided and abetted that fraud," and the "banks' participation in the transactions, *regardless of the purpose and effect of those transactions*, did not give rise to primary liability under §10(b)." *Enron*, 482 F.3d at 386, 390. To reach this result, the Fifth Circuit majority read this Court's precedents as "*narrowly defining the scope of 'fraud' in the context of securities*" (*id.* at 387), and it opted for a "*[s]trict* construction of §10(b)" and a "*limited interpretation of the words of §10*," to preclude liability under the rubric of "deceptive acts" or "scheme." *Id.* at 392-93.

With understatement, the majority noted the Banks' conduct was "'hardly praiseworthy,'" *id.* at 394 n.2, admitting that its "interpretation of §10(b) could have gone in a different direction and . . . established liability for the actions the banks are alleged to have undertaken . . . [as] one of our sister circuits — the Ninth [Circuit] — believes that it did." *Id.* at 393. Acknowledging that "former Enron shareholders who have lost billions of dollars in a fraud" would find the result at odds "with notions of justice and fair play," the Fifth

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[19] Arthur Andersen ("AA") auditors, Thomas Bauer, Michael Odom, Patty Grutzmacher and John Stewart all testified that had they known the truth about the transactions, AA would not have approved the accounting.

Circuit denied the victims of this notorious fraud *even a chance to prove their §10(b) case* on the merits — so as to avoid "opening the floodgates for nearly unlimited and frequently unpredictable liability for secondary actors in the securities markets." *Id.*

Styled a "concurrence," Judge Dennis's opinion is in substance a dissent from the *Enron* majority's analysis on these points. He disagreed with "the majority's cramped interpretation of the statutory language of section 10(b)," that "immunizes a broad array of undeniably fraudulent conduct from civil liability under Section 10(b), effectively giving secondary actors license to scheme with impunity, so long as they keep quiet." *Id.* at 394. Recognizing that "the majority's [decision] is strictly a question about the substantive reach of Section 10(b)" (*id.* at 397), he stated its "narrow interpretation of Section 10(b)" ignored this Court's mandate to construe "the disputed statutory language 'not technically and restrictively, but flexibly to effectuate its remedial purposes.' *SEC v. Zandford*, 535 U.S. 813, 819 (2002)." *Enron*, 482 F.3d at 399-400. Judge Dennis concluded (*id.* at 400-01):

> I see no basis for the majority opinion's strict, narrow reading, and I agree with the district court, the Ninth Circuit [in *Simpson*], Judge Kaplan [in *Parmalat*], and the SEC that Section 10(b)'s prohibition on directly or indirectly employing any "deceptive device or contrivance" can reach secondary actors who, with scienter, engage in fraudulent transactions that are used to inflate an issuer's financial results. *See Simpson*, 452 F.3d at 1050 ("If a defendant's conduct or role in an illegitimate transaction has the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud, then the defendant is using or employing a deceptive device within the meaning of §10(b)"); *Enron*, 2006 U.S. Dist. LEXIS 43146, at *167-74 (adopting SEC view "that a deceptive act includes a transaction whose principal purpose and effect is to create a false appearance of revenues, which can be

accomplished by acts as well as by words") (internal quotation marks omitted); *Parmalat*, 376 F. Supp. 2d at 502-03.

A central question, of course, is whether the words "use or employ . . . any manipulative or deceptive device or contrivance" in §10(b) may encompass the use or employment of a "scheme . . . to defraud" prohibited by Rule 10b-5(a) — thus creating liability for engaging in a scheme to defraud (assuming scienter and all the other elements of §10(b) liability are present) — or whether they are limited to misstatements of fact. The *Enron* majority chose the latter interpretation, as "the rule may not be broader than the statute" and the "district court's definition of 'deceptive device' [to include fraudulent-scheme liability] thus sweeps too broadly." *Enron*, 482 F.3d at 390. Yet, holding that §10(b)'s language is to be interpreted and applied in a "flexible" manner to effectuate its "remedial purposes" (not "narrowly" or in a "strict" manner as the *Enron* majority said), *Zandford* also expressly states "*[t]he scope of Rule 10b-5 is coextensive with the coverage of §10(b)*," 535 U.S. at 816 n.1, foreclosing any conclusion that Rule 10b-5's "scheme to defraud" language is beyond the scope of §10(b).[20]

The *Enron* majority claimed that the need for "certainty and predictability" for "good-faith financial professionals who are attempting to avoid liability" justified its decision. *Enron*, 482 F.3d at 386, 392. *Amicus* agrees that "'certainty and predictability'" are desirable. *Central Bank*, 511 U.S.

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[20] The SEC had alleged the defendant "'engaged in a *scheme to defraud*,'" via a "complaint describ[ing] a *fraudulent scheme*" and "was . . . able to carry out his *fraudulent scheme without making an affirmative misrepresentation*." *Id.* at 820. His "*conduct without more*" was held a violation of §10(b), as "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id. Zandford* supports liability for knowingly engaging in a fraudulent scheme, even if no affirmative misstatement is made.

at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). Market actors like banks should know that if they use or employ a deceptive device or contrivance, while engaging in a scheme to defraud, they will certainly and predictably face liability under §10(b). Such certainty and predictability would further the deterrent purpose of the law, preventing fraud, as banks (and other market participants) are disincentivized to engage in misconduct. Investors are entitled to certainty and predictability too — they should be able to invest their capital in our markets knowing that fraudulent schemes are unlawful and that if they are victimized by deliberately deceptive misconduct they will at least have access to the federal courts to pursue a remedy. That is the kind of certainty and predictability we need to assure the integrity of our markets and to protect investors — the real purpose of our securities laws.

The tortured reasoning of the decision below and of the *Enron* majority are an injustice to the victims of fraud, setting an incorrect and dangerous precedent that misinterprets §10(b) and Rule 10b-5, misapplies *Central Bank*, ignores *Zandford*, and undermines the broad protections that §10(b)/Rule 10b-5 were meant to provide America's investors from deceptive devices and contrivances — including fraudulent schemes.

SUMMARY OF ARGUMENT

The decision below conflicts with the position of the SEC, adopted by the Ninth Circuit in *Simpson*, and by the *Enron* district court. It is, moreover, wrong. When it followed the decision below in this case, the Fifth Circuit majority in *Enron* admitted that the SEC disagreed with its "narrow" and "strict construction" of §10(b), and that its decision *"could have gone in a different direction,"* had it been true to §10(b)'s text. *Enron*, 482 F.3d at 387, 393. Applying that text, this Court's precedents strongly support scheme liability. *See, e.g.*, *Zandford*, 535 U.S. at 820; *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151-53 (1972); *Superintendent of Ins. v. Banker's Life & Casualty Co.*, 404 U.S. 6 (1971).

Circuit court decisions support scheme liability.[21] So do many recent district court decisions.[22] Those who engage in schemes to defraud investors by executing sham transactions to falsify a company's financial results or hide its debt properly face primary liability under §10(b) and Rule 10b-5.

ARGUMENT

I. THE DECISION BELOW AND *ENRON* DEPART FROM THE STATUTORY TEXT

Liability exists under §10(b) for any person who (with scienter) engages in falsifying the financial statements of a public company, whether or not that person independently

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[21] *See Cooper v. Pickett*, 137 F.3d 616, 620 (9th Cir. 1997) *(scheme liability exists* "as long as each defendant committed a . . . deceptive act in furtherance of the scheme"); *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 112 (2d Cir. 1998) (defendant a primary violator if he "'*participated in the fraudulent scheme*;'" noting "lawyers, accountants, and banks who engage in fraudulent or deceptive practices at their clients' direction [are] primary violator[s]"); *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 814-15 (2d Cir. 1975) ("Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'non-disclosures.' *Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws.*"); *Blackie v. Barrack*, 524 F.2d 891, 904 n.19 (9th Cir. 1975) ("Rule 10b-5 liability is not restricted solely to isolated misrepresentations or omissions; *it may also be predicated on a 'practice, or course of business which operates. . . as a fraud . . . .*'"); *Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971) *("[A]ll fraudulent schemes in connection with the purchase and sale of securities are prohibited.").*

[22] *See, e.g., Parmalat*, 376 F. Supp. 2d at 504; *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003); *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 381-82 (S.D.N.Y. 2003); *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336-37 (S.D.N.Y. 2004); *SEC v. Hopper*, No. H-04-1054, 2006 U.S. Dist. LEXIS 17772, at *34-*42 (S.D. Tex. Mar. 24, 2006).

makes a false statement himself, so long as the actor uses or employs a manipulative or deceptive device or contrivance. This is the test mandated by the express language of §10(b) and Rule 10b-5.

The standard applied by the Eighth Circuit below, and by the Fifth Circuit in *Enron*, departs radically from the statutory text's natural meaning. The *Enron* majority even chided the district court in that case for construing §10(b)'s use of the word "deceptive" in line with its ordinary meaning, explaining that it is only "*by ascribing natural, dictionary definitions to the words of the [statute and] rule, that the district court and likeminded courts have gone awry.*" *Enron*, 482 F.3d at 387. The *Enron* majority ruled that "defining 'deceptive' by referring to the same dictionary the [Supreme] Court used to define 'device,' a [sic] — the approach taken by the court in *Parmalat*, 376 F. Supp. 2d at 502, and approvingly cited by the district court . . . *is improperly to substitute the authority of the dictionary for that of the Supreme Court.*" *Enron*, 482 F.3d at 389.

Yet this Court holds that statutory language generally must be interpreted in accord with its *ordinary* meaning.[23] Section §10(b)'s words, in particular, must be accorded their "commonly accepted meaning." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 198-99 (1976).

The Fifth and Eighth Circuits both misconstrue this Court's precedents concerning the term "deceptive." According to this Court's precedents, §10(b)'s prohibition of "*any manipulative or deceptive device or contrivance*" necessarily encompasses a "*scheme to defraud.*" This Court used *Webster's*

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[23] *Pasquantino v. United States*, 544 U.S. 349, 356 (2005) ("'When interpreting a statute, we must give words their ordinary or natural meaning.'"); *Smith v. United States*, 508 U.S. 223, 228 (1993) ("When a word is not defined by statute, we normally construe it in accord with its ordinary or natural meaning.").

International Dictionary (2d ed. 1934) to give content to §10(b)'s terms in *Hochfelder*, 425 U.S. at 188 & nn.20-21. *Hochfelder* referred to dictionary definitions of §10(b)'s words to state that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; *scheme; often, a scheme to deceive; a stratagem; an artifice.*'" *Id.* at 199 n.20. The Court also found that a "contrivance" means "'a scheme, plan, or artifice,'" again quoting *Webster's. Id.; see also Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Clearly, a "scheme" to deceive investors is encompassed in the express language of §10(b), according to the natural, commonly understood meaning of the words of §10(b). Thus Rule 10b-5 — adopted by the SEC to implement §10(b) — properly makes it unlawful for any person "*directly or indirectly* . . . to employ *any* device, *scheme*, or artifice *to defraud*," as well as "*[t]o make any untrue statement[s]*," or to "*engage in any act, practice, or course of business which operates . . . as a fraud or deceit upon any person.*" 17 C.F.R. §240.10b-5.

The Fifth Circuit concluded in *Enron* that "*what the banks are alleged to have done, namely engage in transactions elsewhere that gave a misleading impression* of the value of Enron securities that were already on the market," is beyond §10(b)'s reach. *Enron*, 482 F.3d at 391. The Banks' conduct, executed with the purpose and effect of deliberately creating "a misleading impression of the value of Enron securities" (*id.*), was held not "deceptive" within the meaning of a statute that by its express terms was designed to reach "any manipulative or deceptive device or contrivance" employed by "any person," whether "directly or indirectly." 15 U.S.C. §78j(b). The majority frankly acknowledged that nothing in §10(b) compelled this odd result (*Enron*, 482 F.3d at 393):

> We acknowledge that the courts' interpretation of §10(b) could have gone in a different direction and might have established liability for the actions the banks are alleged

> to have undertaken. Indeed, one of our sister circuits — the Ninth [Circuit] — believes that it did.

Nothing in this Court's decisions suggests that courts may ignore the ordinary meaning of the statute's words to immunize those who deliberately engage in deceptive acts or use contrivances in scheming to mislead investors. Quite the contrary, *Central Bank* held that "the *text* of the 1934 Act does not itself reach those who aid and abet a §10(b) violation," and that this "conclusion resolves the case." 511 U.S. at 177. If the statutory text thus controls then those who engage in deliberately deceptive acts as part of a scheme to mislead investors must be primary violators of §10(b), not mere aiders and abettors.

Yet the *Enron* majority and the court below both rejected §10(b)'s plain meaning. The pertinent text states: "It shall be unlawful for any person, directly or indirectly . . . to use or employ . . . any . . . deceptive device or contrivance." 15 U.S.C. §78j(b). These words cannot sensibly be limited to prohibiting only misstatements. Even under the common law — which the securities laws were meant to enlarge — deception included misleading conduct and active concealment.[24] The common law of deceit and of market manipulation contemporaneous with the 1934 Act's enactment clearly incorporated this principle.[25] Dean William J. Prosser explained:

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[24] The common law of fraud and deceit saw deception in *any conduct* designed to mislead another: "The gist of the action is fraudulently producing a false impression upon the mind of the other party; and, if this result is accomplished it is unimportant whether the means of accomplishing it are words or acts of the defendants." *Stewart v. Wyoming Cattle Ranche Co.*, 128 U.S. 383, 388 (1888); *accord, e.g., United States v. Colton*, 231 F.3d 890, 899-900 (4th Cir. 2000) (following *Stewart*); *United States v. Brown*, 5 F. Supp. 81, 89 (S.D.N.Y. 1933), *aff'd*, 79 F.2d 321 (2d Cir. 1935); *Leonard v. Springer*, 64 N.E. 299, 301 (Ill. 1902).

[25] *See Brown*, 5 F. Supp. at 84-89; A.A. Berle, *Stock Market Manipulation*, 38 Colum. L. Rev. 393, 394-97 (1938); A.A. Berle, *Liability for Stock Market Manipulation*, 31 Colum. L. Rev. 264, 267-71 (1931).

> The representation which serves as the foundation for an action of *deceit may consist of words or conduct.* Any active concealment of the truth, *by words or conduct* creating a false impression or removing an opportunity to discover the facts, is treated as the equivalent of a representation that such facts are not true.

William J. Prosser, *Handbook of the Law of Torts* §86, at 720 (1st ed. 1941).[26] And this Court adheres to "the general rule that a common law term in a statute comes with a common law meaning absent anything pointing another way."[27]

Those who engage in transactions that are deceptive — both in the sense that they gave the false appearance of being

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[26] The *Restatement* is to the same effect: "'Misrepresentation' is used in this Chapter to denote not only words spoken or written but also any other conduct which amounts to an assertion not in accordance with the truth. Thus, words or conduct asserting the existence of a fact constitute a misrepresentation if the fact does not exist." *Restatement of Torts,* §525, cmt. b (1938); *accord Restatement (Second) of Torts* §525, cmt. b (1979). "A misrepresentation may be expressed by acts and conduct as well as in words. A falsehood may be expressed by deeds, acts, conduct, or artifice, as well as in words or assertions; deceptive conduct is equivalent to verbal misrepresentation. A misrepresentation may consist of a combination of conduct and concealment or conduct and language or solely of conduct." 37 C.J.S. *Fraud* §12 (2007).

[27] *Safeco Ins. Co. of Am. v. Burr*, No. 06-84, __ U.S. __, 2007 U.S. LEXIS 6963, at *20-*21 (U.S. June 4, 2007); *accord Neder v. United States*, 527 U.S. 1, 21-22 (1999). Given "the common-law roots of the securities fraud action," *Dura Pharms., Inc. v. Broudo,* 544 U.S. 336, 344 (2005), of course, "it would be highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope than its common law analogs." *Sundstrand Corp. v. Sun Chem. Corp.,* 553 F.2d 1033, 1044 (7th Cir. 1977). "Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry," *Herman & MacLean v. Huddleston,* 459 U.S. 375, 389 (1983), and private actions under §10(b), in particular, "are in part designed to add to the protections provided investors by the common law." *Basic,* 485 U.S. at 245 n.22.

something other than what they were, and in the sense that they were designed to (and did) effect a fraud on investors — should be liable under §10(b). *Enron* provides a clear case in point. The Banks were not only aware of the deception — they actively engaged in the deceptive transactions at its core and thereby committed an active misrepresentation of Enron's condition, and concealment of its debt. Thus, *in effect*, the Banks made a false representation. And, because their deception was aimed squarely at the market, the Banks should be found primarily liable to market participants, even though the deception was communicated to the market through Enron. This Court should not adopt a rule that protects them from liability.

Opinions of the Ninth Circuit in *Simpson*, Judge Harmon in *Enron*, and Judge Kaplan in *Parmalat*, all show that courts can draw a careful distinction between primary and secondary liability in this context. In *Parmalat*, Judge Kaplan dealt with secondary actors (banks) engaging in conduct similar to that at issue in *Enron*:

> In this case, the complaint alleges that the banks' actions in connection with the relevant transactions actually and foreseeably caused losses in the securities markets. The banks made no relevant misrepresentations to those markets, but they knew that the very purpose of certain of their transactions was to allow Parmalat to make such misrepresentations. In these circumstances, both the banks and Parmalat are alleged causes of the losses in question. So long as both committed acts in violation of statute and rule, both may be liable.
>
> This analysis is not an end run around *Central Bank*. If a defendant has committed no act within the scope of Section 10(b) and Rule 10b-5 — as in fact was the case in *Central Bank* — then liability will not arise on the theory that that defendant assisted another in violating the statute and rule. But where, as alleged here, a financial institution enters into deceptive transactions as

> part of a scheme in violation of Rule 10b-5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under Section 10(b) and Rule 10b-5.

Parmalat, 376 F. Supp. 2d at 509-10.

To reject this view requires the statute's words to be reinterpreted: "Directly or indirectly" must be reinterpreted to mean only "directly," since only the maker of a false statement *(i.e.,* the "direct" actor) can be liable. "Use or employ" — the verbs the statute uses in making it unlawful to "use or employ any device or contrivance" — plainly suggest conduct or the operation of a scheme, not just the making of misrepresentations. The plain words "device or contrivance" contradict any limitation on the thing that is "used or employed" to *statements* of fact. Yet the decision below in this case requires reading §10(b) as follows: "It shall be unlawful for any person, directly *[not indirectly] to make [not use or employ]* . . . any deceptive *statement [not device or contrivance].*"

The *Enron* majority said it departed from a natural reading of the statute's words (*Enron*, 482 F.3d at 387), because "[t]he Supreme Court has defined 'device' by referring to a dictionary but has pointedly refused to define 'deceptive' in any way except through caselaw," which the majority construed as deviating widely from the ordinary meaning of what is deceptive. *Id.* at 389. Specifically, the majority construed this Court's insider-trading decisions, *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980), and *United States v. O'Hagan*, 521 U.S. 642, 655 (1997), as creating a general rule that however deceptive a misleading device or contrivance may be in fact, even an inherently misleading "device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure." *Enron*, 482 F.3d at 389. "Enron had a duty to its shareholders," it reasoned, "but the banks did not." *Id.* at 390. Thus, the Banks' conduct in

engaging in contrived transactions to hide Enron's debt and inflate its earnings *in order to mislead investors* could not be deemed "deceptive" as that term is used in §10(b).

The *Enron* majority's opinion misreads this Court's precedents. *Chiarella's* discussion of duty *assumes a claim based on a failure to speak:* "This case concerns the legal effect of the petitioner's silence." 445 U.S. at 226. In an insider-trading case like *Chiarella*, the claim of fraud is grounded in an insider's failure to make required disclosures in connection with a specific securities transaction. *Chiarella* and *O'Hagan* did not at all address whether deliberately deceptive *conduct* can qualify as a deceptive device under §10(b).

"Silence, absent a duty to disclose, is not misleading under Rule 10b-5," this Court observed in *Basic,* 485 U.S. at 239 n.17. In contrast, this case and *Enron* involve the legal effect not of third parties' silence, but of their deceptive conduct. The investors' claims in both cases are grounded not in alleged silence in the face of a duty to speak, but upon the fact that the defendants deliberately engaged in *conduct* to mislead investors by affirmatively taking steps to distort an issuer's financial statements — conduct which the *Enron* majority recognized actually inflated the value of Enron's securities trading in the market.[28]

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[28] *Enron*, 482 F.3d at 382-83. The relevant duty thus is the duty not to engage in conduct that violates the statute, which forbids *"any person"* from engaging in the specified "manipulative or deceptive" conduct. As the *Enron* district court noted:

> [T]he requisite duty is not a duty to disclose, but . . . "the duty not to engage in a fraudulent 'scheme' or 'course of conduct' [that] could be based primarily on an omission."

Enron, 2006 U.S. Dist. LEXIS 43146, at *102. The statute prohibits *"any person"* from employing "any manipulative or deceptive device or contrivance" "in connection with the purchase or sale of any security." 15 U.S.C. §78j(b). The statute by its very plain terms reaches *any person* engaged in "a scheme to misrepresent the publicly reported revenues of a company" because "all participants may be viewed as having acted in

Section 10(b) does not even speak in terms of statements and omissions. It obviously was designed to cover deceptive conduct — as well as deceptive statements and omissions — by making it unlawful "for any person, directly or indirectly, . . . to use or employ . . . any manipulative or deceptive device or contrivance" proscribed by the SEC. 15 U.S.C. §78j(b). Rule 10b-5 addresses misleading statements and omissions in subsection (b), but in subsections (a) and (c) it imposes a duty not to engage in devices or schemes (subsection (a)) or acts, practices or courses of business conduct (subsection (c)) that would "operate as a fraud" on any person. To say that there can be no fraud absent a duty to speak would collapse (a) and (c) into Rule 10b-5(b)'s rule against misleading statements and omissions.

II. THE LIABILITY STANDARD FRAMED BY THE SEC AND ADOPTED IN *SIMPSON* COMPORTS WITH STATUTORY TEXT AND WITH THIS COURT'S PRECEDENTS

While the decision below, and the *Enron* majority, both impermissibly distort §10(b)'s language to do away with scheme liability, the SEC's carefully crafted test, adopted by the Ninth Circuit in *Simpson* and by the district court in *Enron*, is wholly consistent with this Court's decision in *Central Bank*. Aiding-and-abetting liability was barred in *Central Bank* because the words "aid and abet" are not in the statute or rule, and also because aiding-and-abetting liability might be imposed on one who merely assisted in some way another person's violation, without doing anything manipulative or deceptive itself. An aider and abettor could be held liable for violating §10(b) despite doing nothing prohibited by §10(b). By contrast, the prohibition against engaging in

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connection with the purchase or sale of securities." *Simpson*, 452 F.3d at 1051. In *Enron*, in *Parmalat*, the "banks' actions in connection with the relevant transactions actually and foreseeably caused losses in the securities markets." *Parmalat*, 376 F. Supp. 2d at 509.

deceptive conduct or a scheme to defraud flows from the statute's text, imposing liability when an actor, with scienter, does something prohibited by §10(b): use or employ a manipulative or deceptive device or contrivance. Petitioner's theory of liability is true to *Central Bank* and to the controlling statute's words.

Central Bank did not immunize bankers from liability for engaging in complex securities frauds. It recognized: "The absence of §10(b) aiding and abetting liability *does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. . . . In any complex securities fraud, moreover, there are likely to be multiple violators . . . .*" *Central Bank*, 511 U.S. at 191. A scheme often will involve multiple actors, and investors are entitled to allege "that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme." *Cooper*, 137 F.3d at 624.[29]

Central Bank noted its reasoning was "confirmed" by the fact that to accept the plaintiffs' aiding-and-abetting argument would impose §10(b) liability "when at least one element critical for recovery" was absent, *i.e.*, reliance on the defendant's conduct. "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable

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[29] In *Central Bank*, the defendant bank had no commercial relationships with the municipal entity involved, was not its investment bank, was not an underwriter of its securities, and issued no analyst reports about the issuer. It *took no affirmative act that could have affected the trading price of the municipal bonds in issue* — for which there was no trading market. Clearly, that is a significantly different fact pattern from the allegations against the Banks in *Enron*, which engaged in repeated transactions of an inherently deceptive nature with Enron, including contrivances, sham entities and secret no-loss/take-out guarantees — bogus transactions designed to directly distort Enron's financial statements as filed with the SEC and distributed to the investment community — all of which inevitably impacted the trading price of Enron's securities.

without any showing that the plaintiff relied upon the aider and abettor's statements or *actions*." *Central Bank*, 511 U.S. at 180. Allowing plaintiffs to "circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery as mandated by our earlier cases." *Central Bank*, 511 U.S. at 180. This Court cited *Basic*, 485 U.S. 224, which held that reliance is satisfied if fraudulent acts affect the price at which securities trade. *See Central Bank*, 511 U.S. at 180.

But in this case, and in *Enron*, third parties' *deceptive conduct did operate to inflate* the prices of *publicly traded* securities. Indeed, the *Enron* majority acknowledged "the factual probability that the market relied on the banks' behavior and/or omissions," and that what the banks did was to "engage in transactions . . . that gave a misleading impression of the value of Enron securities that were already on the market." *Enron*, 482 F.3d at 383, 391. The reliance element is *satisfied* in a fraud-on-the-market case when securities trading in an open-and-developed market are thus affected. *See Basic*, 485 U.S. at 241-49; *see also Parmalat*, 376 F. Supp. 2d at 505-06.

A long line of this Court's decisions, moreover, recognizes that *deceptive conduct* violates §10(b). In *Superintendent of Ins.*, 404 U.S. 6, a *unanimous* Court upheld a complaint involving a "fraudulent scheme" involving the sale of securities, explaining: "*There certainly was an 'act' or 'practice' within the meaning of Rule 10b-5 which operated as 'a fraud or deceit' on Manhattan, the seller of the Government bonds.*" *Superintendent of Ins.*, 404 U.S. at 9. This Court emphasized:

> "We believe that §10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

Id. at 11 (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)).

In *Affiliated Ute*, the Court observed that "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact," but held that "[t]he first and third subparagraphs are not so restricted." 406 U.S. at 152-53. Thus, the defendants violated Rule 10b-5 by engaging in *"a 'course of business' or a 'device, scheme, or artifice' that operated as a fraud,"* though they had never themselves said anything that was false or misleading. *Id.* at 153. "[T]he 1934 Act and its companion legislative enactments," this Court held, were designed "'to achieve a high standard of business ethics in the securities industry.'" *Id.* at 151. "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Id.*

In *Hochfelder*, this Court noted that a manipulative or deceptive "device," by definition, includes "a scheme to defraud." *Hochfelder*, 425 U.S. at 189 n.20. A scheme, this Court elaborated in *Aaron*, is "'[a] plan or program of something to be done.'"[30] Indeed, a "scheme to defraud" encompasses any "plan designed or concocted for perpetrating a fraud." *Ballentine's Law Dictionary* 1142 (3d ed. 1969). It has long included any scheme to defraud investors by causing securities to trade at fraudulently inflated prices; when §10(b) was enacted such conduct already was an unlawful "scheme to defraud" under the mail-fraud statute.[31] Today it is called

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[30] *Aaron*, 446 U.S. at 696 n.13 ("Webster's International Dictionary (2d ed. 1934) defines . . . 'scheme' as '[a] plan or program of something to be done; an enterprise; a project; as a business *scheme*[, or a] crafty, unethical project . . . .'"). To "scheme" is "[t]o form plans or designs; to devise intrigue." *Webster's International Dictionary* 2234 (2d ed. 1934).

[31] In *Harris v. United States*, 48 F.2d 771 (9th Cir. 1931), for example, "[t]he fraudulent scheme charged . . . was one for the sale of [a mining

a "fraud on the market," actionable under §10(b). *See Basic*, 485 U.S. at 241-47; *Lipton v. Documation, Inc.*, 734 F.2d 740, 744-47 (11th Cir. 1984). Every person who intentionally engages in such a "scheme" to defraud by using a "manipulative or deceptive device or contrivance" is thus a primary violator of §10(b).

In *O'Hagan*, this Court held that liability under §10(b) does not require a defendant to speak, because §10(b) prohibits "'any manipulative or deceptive device or contrivance'" in contravention of SEC rules outlawing "any deceptive device," whether or not the defendant spoke. *O'Hagan*, 521 U.S. at 651.

In *Zandford*, 535 U.S. 813, this Court repeatedly cited with approval its seminal *"fraudulent scheme"* case, *Superintendent of Ins.*, and reversed dismissal, making the following key points:

- "The scope of Rule 10b-5 is coextensive with the coverage of §10(b) . . . ."
- "[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b).
- Allegations that defendant *"engaged in a fraudulent scheme"* or "'*course of business' that operated as a fraud or deceit*" stated a §10(b) claim. *Zandford*, 535 U.S. at 816 n.1, 820-21.

Central Bank clearly — but merely — stands for the proposition that no aiding-and-abetting liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain "aiding and abetting" language. The decision in *Central*

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company's] corporate stock . . . by the manipulation of the price of the stock on the [stock exchanges] and the circulation of false reports concerning the mine through the mails." *Id.* at 774. "In fact, the whole scheme centered around the establishment of an alleged stock exchange value which is in fact wholly fictitious." *Id.* at 775; *see also Brown*, 5 F. Supp. at 84-89; Berle, *Stock Market Manipulation*, *supra* n.25, at 395-97.

Bank is *quite narrow*. By contrast, the language of §10(b) and Rule 10b-5 is broad.

That scheme liability survives *Central Bank* is confirmed by Congress's comprehensive revision of the 1934 Act in 1995, with the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. 104-67, 109 Stat. 737 (1995). Just a year after *Central Bank*, and its statement that "[i]n most complex cases there are likely to be multiple violators," 511 U.S. at 191, Congress substantially revised the law governing the §10(b) private right of action, including the rules for joint-and-several liability when multiple actors engage in a fraudulent scheme. 15 U.S.C. §78u-4(f). Congress provided that *proportionate liability* is the general rule, but that joint-and-several liability applies to all who either (i) make a false statement "with actual knowledge" of its falsity *or* (ii) otherwise *engage in "conduct* with actual knowledge of the facts and circumstances that make *the conduct . . . a violation of the securities laws*." 15 U.S.C. §78u-4(f)(10)(A)(ii). This *"conduct"* language would be superfluous if only the individual actor making a statement could be held liable under §10(b).

III. THE FACTS IN *ENRON* SHOW THAT A CLEAR DISTINCTION MAY BE DRAWN BETWEEN PRIMARY LIABILITY BASED ON DECEPTIVE CONDUCT AND MERE AIDING AND ABETTING

Enron's facts show that a clear distinction may be drawn between mere aiding and abetting and primary conduct designed to mislead. The fraud in that case consisted of hiding Enron's debt and executing sham transactions to falsify Enron's financial results. The Banks that contrived and executed those transactions to hide debt and to generate phony financial results engaged in conduct that was intended — by them — to mislead investors.

In *Enron* many of the bank transactions were completely illusory, often with secret, no-loss guarantees or take-out promises, devoid of any economic substance. Their *only* purpose was to distort Enron's financial statements. And they were executed by *major players in the securities markets. Enron* involves the alleged misconduct of banks — major actors in our nation's financial markets which *Central Bank* identified as secondary actors who "may be liable as primary violators under Rule 10b-5 . . . in any complex securities fraud [where] there are likely to be multiple violators." *Central Bank*, 511 U.S. at 191. The securities acts were passed in large part to remedy the misconduct of the Wall Street banks occurring in the 1920s, as documented by the Pecora Hearings. *See* Francis Pecora, *Wall Street Under Oath: The Story of Our Modern Money Changers* (1939). Such banks are financial sophisticates, operating in the heart of our financial markets — and uniquely positioned to influence the apparent value of the securities of public companies they interact with. Their conduct in dealing with public companies in "structured finance" transactions specifically intended to impact a company's reported financial condition, selling the company's securities to investors, and issuing analyst reports recommending purchase of the company's stock — all conduct that can directly impact the company's stock price — is something that carries with it the potential for substantial harm to investors when banks use or employ manipulative or deceptive devices or contrivances. Such conduct is subject to the anti-fraud provisions of the 1934 Act.

CONCLUSION

Section 10(b)'s broad proscription reaches conduct undertaken with the principal purpose and effect of misleading a company's investors and creditors.

Respectfully submitted,

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Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND FUTURES INDUSTRY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTERESTS OF *AMICI CURIAE*[1]

Amicus SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers that have a vital interest in the outcome of this appeal. These institutions are the gateway to the U.S. capital markets, linking thousands of companies to millions of investors. Among other things, they underwrite equity and debt offerings for domestic and foreign issuers, broker securities trades, provide financial advisory services, publish analysis, lend money to companies ranging from small start-ups to the Fortune 100, and make private-equity investments in large and small companies. In short, these financial institutions are essential to every aspect of the U.S. (and global) capital markets' function. SIFMA's mission is to promote policies and practices that expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally through offices in New York, Washington, D.C., and its associated firm, the Asia Securities Industry and Financial Markets Association, in Hong Kong.

Amicus FIA is a national trade association for the commodity futures and options industry. Its regular membership consists of 35 of the nation's largest futures brokerage firms, and its associate membership consists of approximately 150 firms involved in virtually all other segments of the industry. Many of FIA's members also are securities broker-dealers, investment banks, commercial-bank affiliates, or are otherwise extensively involved in capital market and business transactions.

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[1] Letters of consent from both parties have been filed with the clerk. The Securities Industry and Financial Markets Association ("SIFMA") and the Futures Industry Association ("FIA") state that under Rule 37.6, no counsel for a party authored this brief in whole or in part. No person or entity other than SIFMA, FIA, their members, or counsel made a monetary contribution to this brief's preparation or submission.

This case is enormously important to these financial institutions and the U.S. capital markets. Much like the vendors that petitioner Stoneridge Investment Partners ("Stoneridge") sued in this case, financial institutions routinely provide a broad range of services to and engage in counterparty transactions with public issuers. If Stoneridge's positions were accepted, these institutions would face unprecedented liability risk and litigation expense from private securities-fraud litigation brought by shareholders of issuers that later misreport those transactions in their financial statements. Nothing in the relevant statutory framework, caselaw, or public policy supports such a result.

SUMMARY OF ARGUMENT

The federal securities laws guard against fraud by imposing duties on certain parties in certain contexts to disclose material information. But those duties do not apply equally to all commercial actors. In *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*,[2] for example, the Court held that Section 10(b) does not give rise to "aiding-and-abetting" or conspiracy liability.[3] And since 1994, Congress has consistently reaffirmed *Central Bank*'s wisdom by amending the statute to empower only the SEC to sue securities-fraud aiders and abettors, while further restricting Section 10(b)'s implied private right of action.

Foreshadowing cases like this one, the *Central Bank* dissent correctly predicted that private plaintiffs would recast aiding-and-abetting allegations as primary violations:

> [M]any aiders and abettors will be subject to liability as primary violators. For example, an accountant, lawyer, or other person making oral or written misrepresentations (or omissions, *if the person owes a duty to the injured purchaser or seller*) in connection with the purchase or sale of securities

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[2] 511 U.S. 164 (1994).

[3] *See id.* at 177–78.

> may be liable for a primary violation of § 10(b) and Rule 10b-5.[4]

Thus, the dissent recognized the settled law that a silent secondary actor's failure to disclose could constitute a primary Section 10(b) violation only if the actor had a duty to disclose.

If Section 10(b) did not require that duty as a condition to liability in the nondisclosure context, every routine commercial or financial transaction with a public issuer would become a minefield of private securities-fraud liability exposure. Once an issuer misreports the transaction, shareholder-plaintiffs could sue every anonymous third party that played a role, even if that party never uttered a word publicly. The resulting specter of Rule 10b-5 liability would force every commercial actor to disclose all material information to every other counterparty and its shareholders or other constituents. In this case, the only way that Scientific-Atlanta and Motorola could have protected themselves from potential liability would have been to leapfrog Charter and make a specific disclosure (possibly violating a confidentiality agreement) to *Charter's* shareholders, complete strangers with whom Scientific-Atlanta and Motorola otherwise would never have interacted or communicated.

That is why Stoneridge's scheme-liability theory fails. The duty to make truthful disclosures to Charter's shareholders belonged exclusively to Charter, and thus only Charter could have breached that duty in violation of Section 10(b). At most, Scientific-Atlanta's and Motorola's alleged participation in sham transactions that Charter used to falsify its financials may constitute aiding and abetting securities fraud. But absent their own misstatements or a duty to speak, Scientific-Atlanta and Motorola cannot be found to have committed primary Section 10(b) violations.

Eliminating the duty requirement would especially prejudice financial institutions that routinely provide financial services to or engage in counterparty transactions with public

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[4] *Id.* at 199 n.10 (citations omitted) (emphasis added).

issuers. These institutions would effectively be charged with ensuring the *issuers'* compliance with federal securities laws. Unless the financial institutions prepared their own disclosures (or closely supervised their clients' disclosures), they would regularly face exposure to classes of securities holders to whom they never made any statements or owed any duties, and with whom they never transacted business. The ripple effects of such a regime—which several lower courts adopted after *Central Bank*—are living proof of the harm to the very investor-base that Stoneridge and its *amici* claim to champion. Added transaction and compliance costs put the U.S. capital markets out of reach (or at least make them unattractive) for many issuers and increase the cost of capital prohibitively for many others, driving them to foreign markets and deterring foreign issuers from raising capital in the U.S. The result is fewer opportunities for American investors.

Contrary to Stoneridge's and its *amici*'s shrill cry, an affirmance here would not encourage financial institutions to participate in sham transactions that issuers might use to falsify their financial statements. Financial institutions already face serious consequences for aiding and abetting an issuer's securities-law violations. First and foremost, they can be put out of business as a practical consequence of criminal prosecution. They can also be sued by the SEC or self-regulatory organizations (SROs) (for aiding and abetting the issuer's fraud, or for violating other rules and regulations applicable to financial institutions), and by state regulators and attorneys general (under broad anti-fraud statutes like New York's Martin Act). There is thus no need to distort Section 10(b)'s longstanding duty requirement by recharacterizing classic aiding-and-abetting conduct as a "primary violation."

ARGUMENT

I. A NON-DUTY-BASED SCHEME-LIABILITY REGIME WOULD MULTIPLY LITIGATION EXPOSURE AND INCREASE THE COST OF CAPITAL IN U.S. MARKETS.

At bottom, Stoneridge's espoused theory of "scheme liability" is nothing more than an impermissible private right of action for aiding and abetting securities fraud. Indeed, the Tenth Circuit Court of Appeals in *Central Bank* found the bank's "affirmative" participation in the issuer's "fraudulent scheme" to constitute aiding and abetting (which the court erroneously concluded was actionable).[5] Nonetheless, Stoneridge argues that its allegations regarding Scientific-Atlanta's and Motorola's alleged affirmative participation in Charter's fraudulent scheme fit within *Central Bank*'s description of a "primary" violation. This argument fails because Stoneridge cannot allege against Scientific-Atlanta and Motorola Section 10(b)'s central requirement—a duty to disclose.

A. Section 10(b) and Rule 10b-5 address fraud by imposing disclosure duties on certain market participants.

The Court has repeatedly observed that the securities laws' "fundamental purpose" is to promote "full disclosure."[6] Section 10(b) furthers that purpose by prohibiting the use or employment of "any manipulative or deceptive device or contrivance in

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[5] *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 895, 902 (10th Cir. 1992) (sustaining aiding-and-abetting claim against Central Bank where plaintiffs had alleged that securities "were sold as part of a fraudulent scheme" that Central Bank assisted "by affirmative action, specifically by affirmatively agreeing to delay the independent review of the" property appraisal).

[6] *See, e.g.*, *Cent. Bank*, 511 U.S. at 171; *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8 (1985); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

contravention of such rules and regulations as the [SEC] may prescribe."[7]

SEC Rule 10b-5 and its three subsections effectuate this mandate. Specifically, Rule 10b-5(b) bars *incorrect* and *incomplete* disclosure by imposing a duty on speakers to be truthful and complete—it prohibits "any untrue statement of material fact" or omission "to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[8] Rules 10b-5(a) & (c), in contrast, address conduct that does not involve speaking, and thus apply even where there is *no* disclosure. They prohibit "any device, scheme, or artifice to defraud"[9] and "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[10]

The failure to disclose is essential to Rule 10b-5(a) & (c) liability because there can be no "fraud or deceit" where the nature of the "device, scheme, or artifice" is fully disclosed. In *Santa Fe Industries, Inc. v. Green*, for example, the plaintiff shareholders were "furnished with all relevant information on which to base their decision" either to approve a proposed short-form merger or reject it and exercise their share-appraisal rights.[11] Because "the complaint failed to allege a material misrepresentation or material failure to disclose," the transaction was "neither deceptive nor manipulative and therefore did not violate either § 10(b) of the Act or Rule 10b-5."[12] Just as full

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[7] *See* 15 U.S.C. § 78j(b) (2007).

[8] 17 C.F.R. § 240.10b-5(b) (2007).

[9] *Id.* § 240.10b-5(a).

[10] *Id.* § 240.10b-5(c).

[11] 430 U.S. 462, 474 (1977).

[12] *Id.*; *see also United States v. O'Hagan*, 521 U.S. 642, 655 (1997) ("[F]ull disclosure forecloses liability under the misappropriation theory [of insider trading]: Because the deception essential to the

(Cont'd)

disclosure precludes a fraud claim, the failure to disclose can create one. The Court first made this observation in *Affiliated Ute Citizens v. United States*, when it found that the acts of the defendants—bank employees who had contracted to facilitate Ute tribe members' stock sales to outsiders (including the defendants themselves)—"operated as a fraud . . . because the defendants devised a plan and induced the [plaintiffs] to dispose of their shares *without disclosing to them* material facts that reasonably could have been expected to influence their decisions to sell."[13] Regardless of the specific "act, practice, or course of business"[14] that brought the defendants within the rule, it was their failure to disclose that rendered their conduct fraudulent.

Nondisclosure also underlies the fraud alleged here. As Stoneridge's *amici* concede, "had the truth behind Charter's financial statements been disclosed, there would have been no injury."[15] That is, had Charter announced the terms of its transactions with Scientific-Atlanta and Motorola (rather than just Charter's revenue data), the market would have recognized the transactions for what they were.[16] Thus, the transactions

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(Cont'd)
misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation . . . .").

[13] 406 U.S. 128, 153 (1972) (emphasis added); *see also SEC v. Zandford*, 535 U.S. 813, 820–21 (2002) ("Taking the allegations in the complaint as true, each sale was made to further respondent's fraudulent scheme; each was *deceptive because* it was neither authorized by, *nor disclosed to*, the [client].") (emphasis added).

[14] 17 C.F.R. § 240.10b-5(c) (2007).

[15] Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 14 n.4.

[16] *See, e.g., Ganino v. Citizens Util. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) (explaining that under "truth on the market" corollary to "fraud on the market" doctrine, "a misrepresentation is immaterial
(Cont'd)

themselves did not result in any fraud—rather, investors were allegedly defrauded by Charter's later misrepresentations *about* the transactions. In *amici*'s words, "the plaintiffs' injuries are ultimately traceable to the false statements that Charter issued."[17]

B. A disclosure triggers a duty to speak truthfully, but a failure to disclose gives rise to securities-fraud liability only when it breaches a duty.

Fraud thus boils down to either a knowingly false or misleading disclosure, or a failure to disclose. Charter's false statements were fraudulent because Rule 10b-5(b) imposes a duty on speakers to disclose accurately and completely.[18] In Rule 10b-5(a) and (c) cases involving conduct, not speech, fraud arises from the defendant's failure to disclose his actions.[19] But when a defendant has made no false or misleading statements to investors, silence can give rise to fraud liability only when the defendant breaches a duty to speak. Thus, in *Chiarella v. United States*, the Court found that Section 10(b) incorporated the

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(Cont'd)
if the information is already known to the market because the misrepresentation cannot then defraud the market"); *cf. Basic Inc. v. Levinson*, 485 U.S. 224, 248 (1988) (holding that presumption of reliance in a fraud-on-the-market case may be rebutted by proving that "the 'market makers' were privy to the truth"); *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1094 (N.D. Cal. 1994) (holding that defendant's truthful disclosure of its financial results relieved it of any duty to characterize those results).

[17] Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 17.

[18] *See, e.g., Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 268 (6th Cir. 1998) (holding that Rule 10b-5(b) imposes a duty "to provide complete and non-misleading information with respect to subjects on which [a speaker] undertakes to speak").

[19] *See* Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 14 n.4 ("Because the securities laws are fundamentally directed at disclosure, at bottom, every injury premised on affirmative conduct can be reduced to a failure to disclose.") (citations omitted).

common-law principle that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so."[20]

This duty is essential to any nondisclosure-based Section 10(b) claim. It renders the nondisclosure "deceptive" because the plaintiff is entitled to rely on the defendant for complete information.[21] In contrast, Stoneridge's "scheme" theory—also based on nondisclosure—would impose primary fraud liability on defendants that not only made no disclosures to shareholders, but also owed those shareholders no disclosure duty at all. As the Court has noted (and rejected), such duty-divorced liability would amount to "recognizing a general duty between all participants in market transactions" to disclose all material, nonpublic information or to forgo their transactions entirely.[22]

To say instead that the disclosure duty arises from "conduct"[23] likewise eradicates the duty requirement altogether, because an issuer's counterparties always engage in some "conduct"—whether they are buying goods, selling advertising, making loans, or structuring a transaction. By alleging undisclosed "conduct" as "primary" fraud—such as by artfully

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[20] 445 U.S. 222, 228 (1980).

[21] *See id.* at 234–35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."); *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 385 (5th Cir. 2007). The court in *Regents* concluded:

> It is natural to expect a plaintiff to rely on the candor of one who owes him a duty of disclosure, and it is fair to force one who breached his duty to prove that the plaintiff did not so rely. Here, however, where the plaintiffs had no expectation that the banks would provide them with information, there is no reason to expect that the plaintiffs were relying on their candor.

Id.

[22] *Chiarella*, 445 U.S. at 233.

[23] *See* Br. for *Amici Curiae* States of Ark. *et al.* in Support of Petitioner at 19.

pleading a legitimate transaction as a pejorative "sham"—private plaintiffs simply end-run and effectively eliminate the requirement for a preexisting duty. The resulting dutiless securities-fraud regime, and the expansive liability that would follow, are precisely what the statute does not authorize and this Court has repeatedly rejected.[24]

Instead, the Court has sought only to prevent the "inherent unfairness"[25] of parties exploiting, while failing to disclose, information to which they were afforded special access. In *Chiarella*, the Court adopted the Restatement of Torts' common-law formulation that, absent any false statements, a duty to disclose exists only "when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' "[26] Thus, the duty to disclose "arises from a *specific* relationship between two parties."[27] That relationship may exist among corporate insiders and shareholders[28] or brokers and their clients,[29] but it does not exist between a corporation's shareholders and

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[24] *See Dirks v. SEC*, 463 U.S. 646, 654–55 (1983) (observing that "[n]ot to require" a disclosure duty arising from a fiduciary relationship "would amount to 'recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information' ") (quoting *Chiarella*, 445 U.S. at 233); *id.* at 657 (rejecting "idea that the antifraud provisions require equal information"); *Chiarella*, 445 U.S. at 233 ("Formulation of such a broad duty . . . should not be undertaken absent some explicit evidence of congressional intent. As we have seen, no such evidence emerges from the language or legislative history of § 10(b).").

[25] *See In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968).

[26] *Chiarella*, 445 U.S. at 228 & n.9 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

[27] *Id.* at 233 (emphasis added).

[28] *See, e.g., id.* at 228 (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)).

[29] *See, e.g., SEC v. Zandford*, 535 U.S. 813, 823 (2002).

commercial third parties, such as the corporation's financial-services providers or its third-party vendors. Like the financial-printer employee in *Chiarella*, Scientific-Atlanta and Motorola were "complete stranger[s]" who never interacted with Charter's shareholders.[30] Imposing a duty to disclose to such remote parties would "depart[] radically from the established doctrine" and "should not be undertaken absent some explicit evidence of congressional intent," which, as the Court noted in *Chiarella*, does not exist.[31]

Amici Change to Win and the CtW Investment Group incorrectly rely on the common-law general "duty not to deceive."[32] As both the Court and the Restatement have acknowledged, that duty runs at most only to counterparties in business transactions—not to unidentified third parties (like the counterparty's shareholders) with whom the defendant never interacted or communicated.[33] The Fourth Circuit in *United*

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[30] *See Chiarella*, 445 U.S. at 232–33 ("[Chiarella] was not [the selling shareholders'] agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

[31] *Id.* at 233.

[32] *See* Br. for Change to Win & the CtW Inv. Group as *Amici Curiae* in Support of Petitioner at 16 ("Common law fraud also includes acts taken to conceal, create a false impression, mislead, or otherwise deceive in order to 'prevent[] the other [party] from acquiring material information,' even in the absence of a fiduciary, statutory, or other independent duty to disclose material information.") (citation omitted); Br. of the Am. Ass'n for Justice as *Amicus Curiae* in Support of Petitioner at 14.

[33] *See Stewart v. Wyo. Cattle Ranche Co., Ltd.*, 128 U.S. 383, 388 (1888) ("The gist of the action [for common-law fraud] is fraudulently producing a false impression *upon the mind of the other party* . . . .") (emphasis added); Restatement (Second) of Torts § 550 (1977) ("*One party to a transaction* who by concealment or other action intentionally prevents *the other* from acquiring material information is subject to the same liability . . . .") (emphasis added).

States v. Colton[34] reached the same result in construing the same words in the federal bank-fraud statute on which Stoneridge relies here—"scheme or artifice to defraud."[35] The court applied the common-law rule to conclude that the defendant had directly deceived his counterparty, the Resolution Trust Corporation, by failing to disclose material facts that allowed him to purchase a defaulted note at a discount.[36] Thus, contrary to *amici*'s urging,[37] *Colton*'s logic is no broader than the common law and, even if it applied to Rule 10b-5(a)'s similar language, would not reach defendants who never interacted or communicated with the complaining shareholders.

The common-law cases likewise consistently impose disclosure duties only on business adversaries.[38] Thus, under the common-law rule, Scientific-Atlanta's and Motorola's "duty not to deceive" would run to *Charter*—their business counterparty—not to anonymous Charter shareholders with whom they never interacted or communicated.[39] Even Change to Win's far-afield example of a car dealer resetting an odometer to deceive a buyer illustrates this limitation.[40] The dealer's

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[34] 231 F.3d 890 (4th Cir. 2000).

[35] *See* 18 U.S.C. § 1344 (2007).

[36] *See Colton*, 231 F.3d at 896–99.

[37] *See* Br. for Change to Win & the CtW Inv. Group as *Amici Curiae* in Support of Petitioner at 5, 13, 16 & 22.

[38] *See, e.g., Salzman v. Maldaver*, 24 N.W.2d 161 (Mich. 1946) (aluminum seller concealed corroded sheets from buyer and interfered with buyer's ability to inspect); *Lindberg Cadillac Co. v. Aron*, 371 S.W.2d 651 (Mo. Ct. App. 1963) (seller painted over engine-block crack to conceal it from buyer); *Berkowitz v. Lyons*, 119 A. 20 (N.J. 1922) (seller sold buyer stolen automobile).

[39] *See, e.g., Sachs v. Blewett*, 185 N.E. 856, 858 (Ind. 1933) (dismissing fraud claim where complaint did not allege "any relationship of trust or confidence between the parties, nor are any circumstances shown which would entitle the [plaintiff] to place more than ordinary reliance in the promises of the [defendants]").

[40] *See Dist. Motor Co. v. Rodill*, 88 A.2d 489, 494 (D.C. Ct. App. 1952); Restatement (Second) of Torts § 525 cmt. b (1977).

duty—to disclose the reset odometer or abstain from selling the car—runs only to the buyer, not to the buyer's constituents or subsequent counterparties. This is similar to the duty to disclose or abstain that the Court has held must arise from a "specific relationship between two parties."[41] And of course, the odometer example is several steps removed from this case—unlike the car dealer whose conduct amounts to an affirmative representation about the car under his control, Charter's third-party vendors made no representations (through either words or conduct) to Charter's shareholders and did not control the contents of Charter's financial statements.

C. Stoneridge's non-duty-based Section 10(b) theory would create litigation exposure to anonymous third-parties, raising the cost of accessing the U.S. capital markets without benefiting investors.

Abandoning the duty to disclose as a prerequisite to Section 10(b) liability would expose literally all participants in commercial transactions with public issuers to private securities-fraud litigation—even if they never deceived anyone or uttered a word publicly. For financial institutions, which collectively do business with virtually every company seeking access to the U.S. capital markets, the consequences of Stoneridge's non-duty theory would be especially acute. It would force them to police issuers' disclosures for accuracy and completeness or, worse, implement their own disclosure regime for every transaction with a public company.[42] It would also place financial institutions in the impossible role of assessing a disclosure's materiality to their *counterparty's* shareholders while lacking

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[41] *Chiarella*, 445 U.S. at 233.

[42] *See Dirks v. SEC*, 463 U.S. 646, 653 n.12 (1983) ("The SEC views the disclosure duty as requiring more than disclosure to purchasers or sellers: 'Proper and adequate disclosure . . . can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.' ") (quoting *In re Faberge, Inc.*, 45 S.E.C. 249, 256 (1973)).

complete and accurate information themselves. Setting aside the potential exposure to the counterparty that a misinformed disclosure could create, and the practical conflict if the counterparty were to insist on typical confidentiality protections, such a result would only harm investors by burying them in an avalanche of countless, potentially conflicting disclosures from an issuer's commercial counterparties. As the Court has observed, such information-overload is "hardly conducive to informed decision making."[43]

In other words, Stoneridge's non-duty-based private-right-of-action theory would lead to precisely the "ripple effects" that the Court in *Central Bank* aimed to avoid: "newer and smaller companies may find it difficult" to obtain securities and financial advice and to access the U.S. capital markets, and the financial institutions' "increased costs . . . may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute."[44] The additional compliance costs and litigation expense—not to mention liability risk—would be staggering. Every transaction for which an allegation could be constructed that passes Stoneridge's proposed "purpose and effect" test[45] could put financial institutions at risk for the entire amount of the *issuer's* fraud, as

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[43] *See Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (recognizing that the Court must be "careful not to set too low a standard of materiality" because "a minimal standard might bring an overabundance of information within its reach, and lead management simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making") (internal quotations omitted).

[44] *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994).

[45] Br. for Petitioner at 32 ("A person engages in a deceptive act as part of a scheme to defraud investors, and violates Section 10(b) and Rule 10b-5(a) and/or (c), if the purpose and effect of his conduct is to create a false appearance of material fact in furtherance of that scheme.").

the PSLRA's proportionate-liability protection does not apply to knowing violations.[46] Access to U.S. capital markets would become more expensive as investors and their companies bear the higher transaction costs to compensate financial institutions for soaring expenses. Foreign markets—which limit or prohibit private class actions—would become more attractive to both U.S. and foreign companies, depriving American investors of *bona fide* investment opportunities.[47] The end result: securities class-action litigation, which is already cited as a key deterrent to foreign issuers considering entry into U.S. markets,[48] would continue to sabotage the competitive footing of U.S. capital markets.

These consequences are not a matter of idle speculation. Securities-plaintiffs' lawyers have concocted numerous costly litigation theories post-*Central Bank*—including against SIFMA and FIA members—giving rise to the conflicting circuit rulings that precipitated this appeal.[49] And foreign commentators are

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[46] *See* 15 U.S.C. § 78u-4(f)(2)(A) (2007).

[47] *See* H.R. Rep. No. 104-50, at 20 (1995) ("Fear of [securities] litigation keeps companies out of the capital markets.").

[48] Interim Report of the Committee on Capital Markets Regulation at 11 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30 Committee_Interim_ReportREV2.pdf ("Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market.").

[49] *Compare, e.g., Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006) (holding that primary liability arises from "conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme"); *and In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 504 (S.D.N.Y. 2005) (sustaining claims for primary Section 10(b) violations where complaint alleged that secondary actors had "used or employed a[] device or contrivance with the capacity or tendency to deceive"); *with Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 384 (5th Cir. 2007) (holding that " 'deception' within the meaning of § 10(b) requires that a defendant (Cont'd)

already watching this case closely for fear that Stoneridge's scheme-liability theory, if endorsed, would impose new barriers to foreign trade and investment, and damage transatlantic economic relations.[50]

These adverse consequences greatly outweigh any *de minimis* benefit that an expanded securities-fraud class-action regime might provide. While federal law authorizes appropriate securities-fraud actions, all securities class actions merely pit one group of shareholders against another—the innocent shareholders who happen to own the company when the suit is brought.[51] Indeed, many shareholders—particularly the institutional investors likely to serve as lead plaintiffs—are often on both sides and essentially end up paying themselves (minus substantial attorneys' fees).[52]

Expanding private class actions through Stoneridge's non-duty theory would only increase the likelihood of this circular wealth transfer because the issuer's and the secondary actors' respective shareholders often overlap. Common lead plaintiffs like pension funds and other diversified institutional investors typically own large stakes in the financial-services companies

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fail to satisfy a duty to disclose material information to a plaintiff" and rejecting plaintiffs' theory that "[m]erely pleading that defendants failed to fulfill that duty by means of a scheme or an act" constitutes § 10(b) deception); *and In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 916 (S.D. Tex. 2004) (dismissing claims against secondary actor for "structuring, funding, and executing" transactions that issuer falsely reported because "plaintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent *Central Bank*'s limitations on liability for a secondary actor's involvement in the preparation of false and misleading statements").

[50] *See generally* Br. of Org. for Int'l Inv. *et al.* as *Amici Curiae* in Support of Respondents.

[51] *See* Interim Report of the Committee on Capital Markets Regulation, *supra* note 48, at 11.

[52] *See id.*

that the non-duty theory would most likely affect. For example, the New York State Common Retirement Fund owns more than $2.5 billion of stock in Bank of America, Citigroup, and JPMorgan Chase & Co.[53] Even individual investors with moderately diversified portfolios or mutual-fund ownership would be on both sides in a multi-defendant scheme-liability action. For this reason, a commentator on which the Stoneridge *amici* rely concludes that "[f]rom a compensatory perspective . . . the securities class action performs poorly."[54]

Treasury Secretary Paulson has crystallized the relevant policy concerns: "Our markets are, indeed, the best in the world. Yet we must be vigilant, and we must do everything we can to ensure they stay that way. . . . [T]he fundamental question we must ask is: Have we struck the right balance between investor protection and market competitiveness . . . ?"[55] A non-duty scheme-liability regime advances neither.

D. In contrast to the clear standard that the duty requirement provides, Stoneridge's proposed "purpose and effect" test would create uncertainty and roll back Congress's consistent post-*Central Bank* efforts to limit private securities class actions.

The Court in *Central Bank* emphasized the need for certainty and predictability in Section 10(b) litigation,[56] which,

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[53] *See* N.Y. State Common Ret. Fund Asset Listing as of March 31, 2006, at 8, 14 & 30, *available at* http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/asset_listings_06.pdf.

[54] John C. Coffee, Jr., *Reforming the Securities Class Action: an Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1545 (2006).

[55] Opening Remarks by Treasury Secretary Henry M. Paulson, Jr. at Treasury's Capital Markets Competitiveness Conference (Mar. 13, 2007), http://www.ustreas.gov/press/releases/hp306.htm.

[56] *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994) (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)).

as the Court has long recognized, "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[57] Without clear standards, decisions are " 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business."[58] This uncertainty only increases the *in terrorem* effect inherent in securities-fraud class actions that lends them "a settlement value to the plaintiff out of any proportion to its chance of success at trial."[59] By adhering to the duty to disclose as a prerequisite to Rule 10b-5(a) and (c) liability, this Court would maintain the clear standard that curtails such abuse.

A looser standard—such as Stoneridge's proposed "purpose and effect" test[60]—would ensnare legitimate business conduct in private securities-fraud class-action litigation. Financial institutions design structured-finance transactions, for example, to confer legitimate legal, tax, or accounting benefits, but the complex and dynamic governing rules make such transactions particularly susceptible to securities class-action abuse.[61] Indeed, such abusive litigation has already gained traction in lower courts

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[57] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975); *see also Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007) ("Private securities fraud actions, however, if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law.").

[58] *Cent. Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652); *see also Blue Chip Stamps*, 421 U.S. at 755 ("We do not believe that such a shifting and highly fact-oriented disposition of the issue of who may bring a damages claim for violation of Rule 10b-5 is a satisfactory basis for a rule of liability imposed on the conduct of business transactions.").

[59] *Blue Chip Stamps*, 421 U.S. at 740.

[60] Br. for Petitioner at 32.

[61] *See generally* Br. of the Am. Bankers Ass'n *et al.* as *Amici Curiae* in Support of Respondents at 17–20.

that have applied vague standards similar to what Stoneridge is proposing here.[62] As one district court explained, even though the transactions depicted in the complaint may well have been legitimate, the court was bound at the pleadings stage to sustain securities-fraud claims against the financial-institution defendant.[63]

Even under the newly strengthened *scienter* pleading standard that the Court announced in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[64] Stoneridge's nebulous "purpose and effect" test would nevertheless reward plaintiffs for cherry-picking disadvantageous facts—which cannot necessarily be countered on a motion to dismiss—and ignoring legitimate business justifications. The likely outcome would be to penalize legitimate capital-raising behavior by adding the unnecessary litigation costs and coercive settlement payments that the Court has condemned.[65]

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[62] *See supra* note 49 and accompanying text.

[63] *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 504 n.160 (S.D.N.Y. 2005). The court observed:

> [I]t is possible that Parmalat never sold bad invoices to Citigroup but simply misrepresented the effect of the securitization transactions on its financial health. On this view, the relevant allegations likely would fail to state a claim against Citigroup [because] Citibank would not have committed a deceptive act but rather merely facilitated Parmalat's misstatements. At this stage, however, the Court is obliged to draw from the complaint all reasonable inferences in the plaintiffs' favor and therefore assumes for present purposes that Citigroup securitized worthless invoices.

Id.

[64] 127 S. Ct. 2499, 2513 (2007) ("A plaintiff alleging fraud in a § 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference.").

[65] *See Cent. Bank*, 511 U.S. at 189 ("Because of the uncertainty of the governing rules, [defendants] may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial.").

Stoneridge's relaxed "purpose and effect" test would thus roll back Congress's efforts to contain frivolous private securities-fraud litigation at the pleadings stage. Congress has noted the importance of a rigorous standard to prevent strike-suit plaintiffs from leveraging the burden and expense of discovery into a nuisance-value settlement.[66] To that end, Congress has legislated repeatedly over the past twelve years to restrict private securities class-action litigation. In 1995—the year after *Central Bank*—Congress enacted the PSLRA to rein in the rampant securities class actions that were "being used to injure 'the entire U.S. economy.' "[67] Consistent with that approach, Congress chose *not* to expand Section 10(b)'s private right of action to include aiding-and-abetting or conspiracy liability, even though it extended the SEC's enforcement authority to exactly that conduct.[68] Similarly in 1998, Congress enacted SLUSA to stop private plaintiffs from circumventing the PSLRA by filing the same frivolous securities lawsuits in state court.[69] And even after the highly publicized corporate scandals of 2001 and 2002, Congress responded (in the Sarbanes-Oxley Act) by legislating more stringent corporate-governance requirements and greater SEC enforcement

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[66] *See* S. Rep. No. 104-98, at 7 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 686 ("If a defendant cannot win an early dismissal of the case, 'the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.' ") (quoting then-SEC Chairman Arthur Levitt); *see also Cent. Bank*, 511 U.S. at 189 (noting Congress's concern over the excessive sums that secondary actors are forced to spend "even for pretrial defense and the negotiation of settlements") (citing 138 Cong. Rec. S12605 (Aug. 12, 1992) (remarks of Sen. Sanford)).

[67] *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (quoting H.R. Rep. No. 104-369, at 31 (1995)) (discussing PSLRA's legislative history and purpose).

[68] *See* 15 U.S.C. § 78t(e) (2007).

[69] *See* 15 U.S.C. § 77p(b) (2007) (preempting any "covered class action based upon the statutory or common law of any State" that alleges securities fraud).

authority[70]—and *rejected* the expansion of private securities-fraud liability that Stoneridge urges here.[71]

II. EXISTING FEDERAL AND STATE LAWS PROVIDE ADEQUATE DETERRENCE AGAINST POTENTIAL AIDERS AND ABETTORS AND AMPLE INVESTOR PROTECTION.

Stoneridge sounds a false alarm by declaring that the Court's unwillingness to expand "scheme liability" would "create a moral hazard encouraging fraud."[72] It depicts a doomsday scenario in which secondary actors would be emboldened to aid and abet others' fraud.[73] Stoneridge's hyperbole is flatly refuted by the ample deterrence of aiding and abetting, and means for restitution, that exist from (i) numerous federal criminal, regulatory, and civil penalties; and (ii) state-law regulatory consequences.

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[70] *See, e.g.*, 15 U.S.C. § 7241(a) (2007) (requiring issuer's "principal executive officer or officers and principal financial officer or officers" to certify the "effectiveness of the issuer's internal controls"); *id.* § 7262(a) (requiring issuers' annual reports to include an "internal control report" that states management's responsibility "for establishing and maintaining an adequate internal control structure and procedures for financial reporting"); *see also* Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 3 (2002) (conferring on the SEC the power to enforce all provisions of the Act).

[71] *See* 148 Cong. Rec. S6575-02, S6584 (daily ed. July 10, 2002) (describing Senator Shelby's proposed amendment to include a "private litigation" provision that "persons that aid or abet violations . . . shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided"); *see also* H.R. Rep. No. 107-414, at 54 (2002) (lamenting that Congress did not "heed these recommendations" to expand the private right of action).

[72] Br. for Petitioner at 35.

[73] *Id.* ("[C]ompanies will quickly learn that they can get away with fraud.").

A. Federal criminal penalties are a professional death sentence for most secondary actors, including financial institutions.

The Justice Department's vigorous prosecution of securities-law violations provides a potent deterrent to aiding and abetting fraud. Since its creation in 2002, the Corporate Fraud Task Force has charged more than 1,300 defendants and secured more than a thousand corporate fraud convictions, including the convictions of a hundred CEOs or corporate presidents.[74] The Department's success is partly attributable to its broad statutory powers to punish secondary actors who assist others in committing securities fraud—the same targets of Stoneridge's suit here. That is, the United States Code criminalizes aiding and abetting violations of the securities laws and mail and wire fraud,[75] as well as conspiracy to violate those laws.[76] Prosecutors are further able to return ill-gotten gains directly to injured shareholders through restitution and forfeiture[77]—without the hefty contingency-fee payout to plaintiffs' lawyers.

The threat of a criminal indictment is a serious deterrent—because even an indictment, and certainly a conviction, would amount to a professional death sentence.[78] One need look no

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[74] *See* U.S. Dep't of Justice, Fact Sheet: Corporate Fraud Task Force (Aug. 9, 2006), *available at* http://www.usdoj.gov/opa/pr/2006/August /06_odag_521.html.

[75] *See* 18 U.S.C. § 2 (2007).

[76] *See id.* § 371.

[77] *See id.* § 3572 (restitution must be paid before fines and penalties); *id.* § 981(a)(1)(D) & (E) (forfeiture of proceeds from mail and wire fraud).

[78] *See, e.g.*, Kurt Eichenwald, *Brokerage Firm Admits Crimes in Energy Deals*, N.Y. TIMES, Oct. 28, 1994, at A1 (" '[C]riminal prosecution of these types of [securities] firms can be the equivalent of the corporate death penalty . . . .' ") (quoting former SEC Commissioner Joseph Grundfest).

further for evidence than Arthur Andersen LLP, which was forced to shut its doors and terminate most of its 28,000 U.S. (and 85,000 worldwide) employees[79] after a conviction on just one obstruction-of-justice count (that was ultimately reversed).[80] Before Arthur Andersen, Drexel Burnham Lambert—once the nation's fifth largest securities firm—collapsed and laid off 5,400 employees after pleading guilty to securities charges.[81] And these existence-threatening risks are not limited to Wall Street and corporate America; they affect any business that depends on its reputation and the public's trust. For example, two major plaintiffs' law firms have recently struggled to retain clients following a criminal investigation and indictment[82] because, as one lead plaintiff declared, the "indictment so taint[s the firm] that neither it nor its attorneys—even those not specifically targeted . . . should continue to serve as class counsel."[83]

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[79] Jonathan D. Glater, *Last Task at Andersen: Turning Out the Lights*, N.Y. TIMES, Aug. 30, 2002, at C3.

[80] *See Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005) (reversing obstruction-of-justice conviction).

[81] *See Key Events in the Prosecution*, N.Y. TIMES, Apr. 21, 1990, at 1; Pat Widder, *Timing Helps Salomon Beat Drexel's Fate*, CHI. TRIB., May 24, 1992, at C1 ("Drexel paid $650 million, pleaded guilty to six felonies and floundered; the firm was driven into bankruptcy.").

[82] *See, e.g.*, Order, *In re New Motor Vehicles Can. Exp. Antitrust Litig.*, 03-MDL-01532-DBH (D. Me. Dec. 18, 2006) (granting motion to remove Milberg Weiss from leadership position in multi-district litigation because of criminal indictment's taint); Order, *In re Medtronic, Inc. Implantable Defibrillator Prod. Liab. Litig.*, 05-MDL-1726-JMB-AJB (D. Minn. June 5, 2006) (ordering *sua sponte* the removal of Milberg Weiss from the Plaintiffs' Steering Committee—even though there were no allegations that the attorney handling case had violated any laws—because of firm's criminal indictment); Order, *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 02-CV-1152-M (N.D. Tex. Feb. 28, 2007) (granting lead plaintiffs' motion to replace Lerach as lead counsel).

[83] Reply Br. of Lead Pl. in Support of Mot. for Substitution of Lead Counsel at 7, *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 02-CV-1152-M (N.D. Tex. Dec. 27, 2006).

Even when corporate defendants are able to avoid criminal prosecution by cooperating with the government, they still face stiff financial penalties and reputational damage. For example, CIBC was forced to exit *entirely* the U.S. structured-finance business—a legitimate and profitable field for financial institutions—as part of its deferred-prosecution agreement arising from Enron.[84] In a similar agreement relating to its tax-shelter practice, the accounting firm KPMG agreed to pay a *$456 million* penalty and abandon three of its businesses to avoid criminal charges that KPMG "knew . . . would probably kill it."[85]

And on facts similar to *Stoneridge*, AOL/Time Warner agreed to pay $210 million in investor restitution and penalties to resolve charges of aiding and abetting PurchasePro's revenue misstatements.[86] The criminal complaint had charged AOL with entering sham transactions (in which AOL received $70 million plus stock warrants) that its counterparty, PurchasePro, later used to report inflated revenue. Illustrating the pressure that prosecutors can exert, the $210 million that AOL paid to resolve the criminal charges was *greater* than the benefit it received from the challenged transaction.

This case itself illustrates that the government can and will punish vendor conduct that aids and abets an issuer's fraud on the market. As Stoneridge notes,[87] four Charter officers were

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[84] Press Release, U.S. Dep't of Justice, Canadian Imperial Bank of Commerce Agrees to Cooperate with Enron Investigation (Dec. 22, 2003), *available at* http://www.usdoj.gov/opa/pr/2003/December/03_crm_718.htm.

[85] David Reilly, *Narrow Escape: How a Chastened KPMG Got by Tax-Shelter Crisis — Boss of Just Three Days Admitted Firm's Sins, Fought to Keep Clients*, WALL ST. J., Feb. 15, 2007, at A1.

[86] *See* Press Release, U.S. Dep't of Justice, America Online Charged with Aiding and Abetting Securities Fraud (Dec. 15, 2004), *available at* http://www.fbi.gov/dojpressrel/pressrel04/aolrelease121504.htm.

[87] Br. for Petitioner at 37.

indicted for their roles in the alleged transactions on 14 counts of mail fraud,[88] wire fraud,[89] conspiracy to commit mail and wire fraud,[90] and aiding and abetting mail and wire fraud.[91] The charges led to guilty pleas, a combined 26 months of prison time, and $775,000 in personal fines.[92]

B. The SEC has responded to Congress's decision to expand its—and not private plaintiffs'—enforcement and recovery powers.

The SEC's broad powers and lengthy record of pursuing wrongdoers and returning funds to investors further belie the Stoneridge *amici*'s argument that the government is "ill-equipped" to enforce the securities laws on a large scale.[93] Indeed, Congress thought just the opposite when it expanded the SEC's mandate in 1995 to include bringing suits against secondary actors for aiding and abetting securities violations.[94] And by passing the Sarbanes-Oxley Act's FAIR Funds provision, Congress once again rejected a proposal to overrule *Central Bank* by expanding private litigation to include aiding and abetting,[95] instead favoring greater SEC enforcement authority. It directed the SEC to create a fund to collect and return to injured investors monies that the SEC recovers through disgorgement and civil penalties.[96]

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[88] *See* 18 U.S.C. § 1341 (2007).

[89] *See id.* § 1343.

[90] *See id.* § 371.

[91] *See id.* § 2.

[92] Judgment, *United States v. Barford*, No. 4:03CR00434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. Kalkwarf*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. McCall*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. Smith*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005).

[93] *See* Br. of the N. Am. Sec. Adm'rs Ass'n, Inc. as *Amicus Curiae* in Support of Petitioner at 19.

[94] *See* 15 U.S.C. § 78t(e) (2007).

[95] *See supra* note 71 and accompanying text.

[96] *See* 15 U.S.C. § 7246 (2007).

The FAIR Funds provision's sponsors sought to compensate investors without incurring the high legal fees associated with private class-action litigation and to ensure that "[t]his money is [used] for investors' retirement accounts, not oceanfront estates for ambulance-chasing trial lawyers."[97] The statute is thus designed to recapture "[n]inety percent or more of forfeited ill-gotten gains . . . [for] injured investors"[98]—a huge benefit considering that legal fees can account for a substantial portion of any private recovery, even when institutional or state plaintiffs have the leverage to " 'drive a hard[] bargain' with law firms."[99] In Ohio's securities class-action settlement with AOL, for example, $31 million of the $175 million settlement went to pay the plaintiffs' lawyers' fees and expenses.[100]

The SEC has embraced its increased authority. From 2002 to 2006, it collected more than *$8 billion* for distribution to investors through the FAIR Funds program.[101] And just as the Justice Department has used its criminal powers against vendors who aid and abet an issuer's fraud on the market, the SEC has similarly used its enforcement authority. In fact, it has already obtained large recoveries from Scientific-Atlanta and Motorola for their alleged aiding and abetting.[102] The SEC has (i) sued

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[97] *See* Press Release, Office of Rep. Richard H. Baker, U.S. House of Representatives, Returning Funds to Defrauded Investors (Jul. 17, 2002) (announcing proposed FAIR Funds provision to the Sarbanes-Oxley Act) (quoting Rep. Michael G. Oxley); *see also id.* ("Unless we act on behalf of investors, this money merely will be transferred from greedy corporate executives to greedy trial lawyers.") (quoting Rep. Michael G. Oxley).

[98] *See id.*

[99] Peter Krouse, *Ohio Gains $144 Million for Pensions in Settlement*, CLEVELAND PLAIN DEALER, Mar. 8, 2007, at A1.

[100] *See id.*

[101] *See* SEC, 2006 Performance and Accountability Report at 23 (2006), *available at* http://www.sec.gov/about/secpar2006.shtml.

[102] *See* Br. for Petitioner at 37.

Scientific-Atlanta for entering transactions with another cable company that were nearly identical to those it entered with Charter; (ii) recovered $20 million in disgorgement through a settlement with Scientific-Atlanta;[103] and (iii) recovered $25 million in civil penalties from Motorola for the same conduct.[104]

Not only can the SEC sue secondary actors as aiders and abettors under Section 20(e),[105] it can also sue them for violating Section 13 (as it did Scientific-Atlanta),[106] which addresses the accuracy of corporate books and records. Rule 13b2-2(b)(1),[107] which the SEC adopted to enforce Section 303(a) of the Sarbanes-Oxley Act,[108] applies *primary liability* to customers, vendors, creditors, accountants, attorneys, securities professionals, or other advisors who, under the direction or request of an issuer's officers or directors, (i) provide false or misleading information to auditors, (ii) enter into "side agreements" that enable issuers to mislead auditors, or (iii) place pressure on auditors that compromises the audit report's integrity.[109] Accordingly, if a secondary actor provides false

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[103] *See SEC v. Scientific-Atlanta, Inc.*, SEC Litig. Release No. 19735 (Jun. 22, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19735.htm.

[104] *See In re Motorola, Inc.*, SEC Exchange Act Release No. 55,725 (May 8, 2007), *available at* http://www.sec.gov/litigation/admin /2007/34-55725.pdf.

[105] *See* 15 U.S.C. § 78t(e) (2007).

[106] *See id.* § 78m(b) (2007); *see also supra* note 103 and accompanying text.

[107] *See* 17 C.F.R. § 240.13b2-2(b)(1) (2007) ("No officer or director of an issuer, or *any other person acting under the direction thereof*, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements . . . .").

[108] 15 U.S.C. § 7242(a) & (b) (2007).

[109] Improper Influence on Conduct of Audits, Exchange Act Release No. 34–47890, Investment Company Act Release No. 26,050, 68 Fed. Reg. 31820, 31821–22 (2003).

documents to an issuer's auditor—even without uttering a word publicly—the SEC also could sue it as a primary Rule 13b2-2(b)(1) violator.

In addition to the SEC's enforcement power, it also oversees self-regulatory organizations, such as the Financial Industry Regulatory Authority,[110] which can bring disciplinary actions against securities firms and their employees who aid and abet another's Section 10(b) violation.[111]

C. State penalties and recovery methods broadly encompass aiding and abetting securities-law violations.

Besides the formidable deterrence the DOJ, SEC, and SROs provide, a broad array of state-law penalties also deters secondary actors from aiding securities violations. These include state "blue sky" laws that permit attorneys general and state regulators to seek fines and obtain restitution from,[112] and impose

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[110] The Financial Industry Regulatory Authority ("FINRA") is the nongovernmental regulatory body created in 2007 by the consolidation of the National Association of Securities Dealers, Inc. and the New York Stock Exchange's regulation, enforcement, and arbitration functions. FINRA currently regulates all securities firms doing business in the United States.

[111] *See Dep't of Enforcement v. Perles*, CA F980005, 2000 NASD Discip. LEXIS 9, at *20–24 (Aug. 16, 2000) (holding that *Central Bank* does not apply to NASD's interpretation of its own Conduct Rules and that aiding and abetting another's securities fraud violates NASD Conduct Rule 2110), *aff'd in relevant part*, Exchange Act Release No. 45691, 2002 SEC LEXIS 847 (Apr. 4, 2002); *see also, e.g., Dep't of Enforcement v. J. Alexander Sec., Inc.*, CA F010021, 2004 NASD Discip. LEXIS 16, at *45–46, 65–69 (Aug. 16, 2004) (holding that aiding and abetting another's securities fraud violates NASD Conduct Rule 2110, and barring aider and abettor from associating with any NASD firm).

[112] *See, e.g.*, Del. Code Ann. tit. 6, § 7325 (2007) (permitting the commissioner to fine and order restitution form any person "who aids and abets any person who wilfully violates any provision of [the

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criminal sanctions against,[113] anyone who aids state securities-law violations. For example, in recent years, the New York attorney general has successfully used New York's Martin Act to recover more than $5 billion in securities-fraud settlements.[114] And state attorneys general have actively pursued aiders and abettors.[115]

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Delaware Securities Act]"); Cal. Corp. Code §§ 25403(b), 25530–25536 (2007) (permitting the commissioner to take action against any person who knowingly provides substantial assistance to another's violation of California's securities laws); *State v. McLeod*, 12 Misc. 3d 1157(A), 2006 WL 1374014, at *11 (N.Y. Sup. Ct. 2006) (holding that a defendant's mere participation in another's stock-spinning scheme "is sufficient to subject [that defendant] to the Martin Act's reach") (citing N.Y. Gen. Bus. Law, Art. 23-A §§ 352(1) & 352-c(2)).

[113] *See, e.g.*, N.Y. Gen. Bus. Law, Art. 23-A §§ 352-c(4)–(6), 352-d, 358 (authorizing criminal penalties and prosecution for violations of Martin Act's anti-fraud provisions); Del. Code Ann. tit. 6, § 7325 (2007) (authorizing criminal prosecution of any person who willfully aids and abets a violation of securities laws); Cal. Corp. Code §§ 25540–25542 (same); 815 Ill. Comp. Stat. § 5/14 (same).

[114] Paul Davies, *Spitzer's Successor May Not Follow in His Footsteps—Cuomo Targets Medicaid Fraud, Guns, Government Corruption; Grasso Case Will Be Early Test*, WALL ST. J., Nov. 11, 2006, at B1.

[115] *See, e.g.*, Press Release, N.Y. State Att'y Gen., Former Trust Company Officials Arrested in Late Trading Fraud (Nov. 25, 2003) (announcing that the combined efforts of the New York Attorney General, SEC, and Office of the Comptroller of Currency had resulted in felony charges against three of Security Trust Co.'s executives for assisting in mutual-fund late trading and had led to the firm's dissolution), *available at* http://www.oag.state.ny.us/ press/2003/nov/nov25a_03.html; *SEC v. J.P. Morgan Chase & Co.*, SEC Litig. Release No. 18252 (Jul. 28, 2003) (announcing civil complaint and $135 million settlement achieved "in coordination with the New York County District Attorney's Office" arising from bank's aiding and abetting accounting fraud), *available at* http://www.sec.gov/litigation/litreleases/lr18252.htm; *SEC v. Southmark*
(Cont'd)

CONCLUSION

The essence of securities fraud is making material misstatements or failing to disclose despite a duty to do so. That is fair game for private securities-fraud liability. The securities laws do not, however, allow private plaintiffs to sue third parties that owed them no duties and indeed may never have deceived them at all. Yet that is precisely what Stoneridge's scheme-liability theory would accomplish. For financial institutions that collectively do business with virtually every company seeking to access the U.S. capital markets, the consequences of applying Stoneridge's radical liability theory would be especially costly. Added litigation and compliance costs would further weigh down the U.S. capital markets in the global race to lure companies and investors. And this handicap would yield no corresponding benefits, considering the litany of other fraud deterrents and investor remedies. In the end, the only clear winners would be plaintiffs' lawyers, who would have won the right to sue additional parties for the issuer's fraud, all in pursuit of deep pockets to pay higher fees. Congress has repeatedly refused to give the lawyers that windfall, and this Court should decline that same invitation. The Court of Appeals' judgment should be affirmed.

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In the

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STONERIDGE INVESTMENT PARTNERS, LLC.,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether this Court should imply a private cause of action under Section 10(b) of the Securities Exchange Act against vendors whose transactions with a publicly-traded company were improperly accounted for by the public company in its financial statements, when the vendors did not use or employ a deceptive device in connection with the purchase or sale of a security and the plaintiff—an investor in the public company—did not rely on the transactions or on any statement by the vendors.

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INTEREST OF *AMICUS CURIAE*[1]

The Washington Legal Foundation ("WLF") is a non-profit public interest law and policy center based in Washington, D.C., with supporters in all fifty States. WLF devotes a substantial portion of its resources to defending and promoting free enterprise, individual rights, and a limited and accountable government. To that end, WLF has appeared before this and other federal and state courts in numerous cases raising issues relating to the proper scope of the federal securities laws. *See, e.g.*, *Credit Suisse Serv. LLC v. Billing*, 127 S. Ct. 2383 (2007); *Kircher v. Putnam Funds Trust*, 126 S. Ct. 2145 (2006); *Asher v. Baxter Int'l, Inc.*, 377 F.3d 727 (7th Cir. 2004), *cert. denied*, 544 U.S. 920 (2005); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); *In re Stock Exchs. Options Trading Antitrust Litig.*, 317 F.3d 134 (2d Cir. 2003).

WLF is submitting this brief out of concern about abusive securities class-action litigation and the substantial costs it imposes on the United States' economy and the shareholders who invest in our Nation's publicly traded corporations.

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[1] Petitioners and respondents have consented to the filing of this brief in letters on file with the Clerk's office. Pursuant to S. Ct. R. 37.6, *amicus* states that no counsel for a party authored this brief in whole or in part. No person or entity, other than *amicus* and its counsel, contributed monetarily to the preparation or submission of this brief.

INTRODUCTION AND SUMMARY OF ARGUMENT

A generation ago, Justice Powell warned in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), that "subjective" and "open-ended" liability standards under federal securities laws are likely to prompt more frauds inside the judicial system than the frauds outside the system they aim to deter and redress. *Id.* at 761 (Powell, J., concurring). Justice Powell joined the majority's opinion in *Blue Chip Stamps*, but also separately concurred, emphasizing that the Court "should strike a balance between the opportunities for fraud" presented by the "contending" liability standards from which the Court was obliged to choose. *Id.* at 760. Justice Powell described the very real risks that, under the legal standard favored by the *Blue Chip Stamps* dissent, "an honest offeror could be confronted with subjective claims by plaintiffs" that, while fraudulent, would be difficult to disprove. *Id.* at 761. He warned that the types of suits the dissent would encourage "could result in large damage claims, costly litigation," and "generous settlements to avoid such cost." *Id.* at 761 n.5. And he noted that "the shareholders of the defendant corporations—the 'investing public'—would ultimately bear the burden of this litigation, including the fraudulent suits that would not be screened out" under the dissent's malleable liability standard. *Id.* Justice Powell concluded, with characteristic succinctness, that a rule allowing "open-ended litigation" would "itself be an invitation to fraud." *Id.* at 761.

Today, 32 years after *Blue Chip Stamps*, and thirteen years after the Court's analogously reasoned

decision in *Central Bank of Denver, N.A. v. First Interstate Bank*, 511 U.S. 164 (1994), Stoneridge Investment Partners, LLC and its *amici* present the same types of arguments—and commit the same fallacies—that *Blue Chips Stamps* exploded. Like the *Blue Chip Stamps* dissenters, Stoneridge and its *amici* fail to grapple seriously with the problem of striking "a balance between the opportunities for fraud" entailed by contending liability standards now being urged upon this Court. Like the *Blue Chip Stamps* dissenters, Stoneridge and its *amici* fail to appreciate the close correlation between subjectivity in securities law liability standards and opportunities for plaintiffs to inflict real injustice—including the injustice of outright fraud—through "open-ended litigation" that is not easily avoided or resolved. Finally, Stoneridge and its *amici* repeatedly lapse into presuming there is some necessary and inevitable tension between the interests of "defendant corporations" and those of the "investing public," overlooking what Justice Powell saw so clearly: because "defendant corporations" are owned by the "investing public," the investing public "ultimately" bears the burden of lawsuits filed against those corporations. *Blue Chip Stamps*, 421 U.S. at 761 n.5.

This case is about fraud. But the issues and risks of fraud it principally concerns have little to do with the fraud perpetrated by the management of Charter Communications, Inc. on Charter's investors, or the supporting role in that fraud that Stoneridge alleges was played by Scientific-Atlanta and Motorola. The real question of fraud presented here is the danger that, distracted by the arguments of Stoneridge and its *amici*, the Court might overlook that the

investing public ultimately bears the burden of any further increase in potentially abusive litigation enabled by subjective liability standards. For the reasons set forth below, the Eighth Circuit's decision dismissing Stoneridge's complaint should be affirmed.

First, securities class action litigation presents special opportunities for abuse. The essential building blocks of a securities class action—eligible plaintiffs, perceptible harms, a plausible tale of fraudulent misrepresentation, and willing counsel—are present *every* time a public company experiences a drop in share price. Moreover, the path to recovery in securities class actions is paved by fraud-on-the-market theories of reliance, plus the settlement pressures brought to bear by even small possibilities of large liabilities. Against this backdrop, fuzzy liability standards amount to an open "invitation to fraud" accomplished through the federal courts. (*See* Section I, below).

Second, unless shaped and limited with care, the litigation vehicle of the judicially-crafted private securities action threatens to undermine the benefits of law enforcement by the Securities and Exchange Commission, by the Department of Justice, by state law enforcement officials, and by private parties proceeding under less abuse-prone theories of liability. In light of the explosive growth in securities litigation in the last ten years, and the ever-present potential for abuse, the Court should be especially wary of Stoneridge's invitation to impose liability on third-party vendors lacking any tangible participation or financial interest in the relevant securities market activity. Such expansive liability

does not deter fraud, but it does undermine the credibility of the justice system and it inevitably harms the very investors the law is supposed to protect. (*See* Section I.B., below.)

Third, abusive securities class action litigation harms the economy more generally, by reducing the competitiveness of the United States' public securities markets. Studies show that the Nation's public markets are losing their position as global leaders in large part due to the growing international perception that the United States' legal system is costly, unpredictable, and out of control. Opening the door for class action litigation against these third-party vendors, who dealt in set-top boxes not securities, would exacerbate the reputational decline of our legal system in the eyes of foreign nations. (*See* Section II, below.)

Finally, because Motorola and Scientific-Atlanta entered into arm's-length, non-financial transactions with Charter, the Eighth Circuit correctly determined that they should be excused outright from any liability under section 10(b) of the Securities Exchange Act. Arm's length transactions involving ordinary goods cannot give rise to a federal *securities* fraud. Drawing a bright line that leaves such transactions (even fraudulent ones) outside the remedial scope of the securities laws is essential if abuse of the private securities class action is to be avoided. (*See* Section III, below.)

ARGUMENT

I. Private Securities Class Litigation Is Especially Susceptible To Abuse, In Ways That Undermine Its Goals of Protecting Investors And Deterring Fraud.

The Court should affirm the judgment below and reject Stoneridge's invitation to employ the securities laws to impose potential section 10(b) liability on activities that do not involve the securities markets. Expanding liability, as Stoneridge requests, would open the door to the most egregious forms of abusive litigation, while providing few (if any) benefits.

A. Abusive Securities Litigation Is A Well-Recognized Problem.

This Court has recognized the problems of abusive litigation in a wide variety of contexts. *See, e.g., Bell Atl. Corp. v. Twombly*, 127 S. Ct. 1955 (2007) (class actions); *Leegin Creative Leather Prods. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007) (antitrust); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996) (tort law). Although intended to provide justice, at least to the extent practicable, the American litigation system may also create opportunities that, "if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007).

The danger of abusive litigation is especially acute in this case. In the context of securities class actions, a variety of factors combine to ensure that (i) class litigation is routinely brought in the wake of large or precipitous drops in the stock price of a

publicly traded company, and (ii) a large portion of filed actions that survive motions to dismiss settle before their merits are ever tested before a neutral trier of fact. In today's litigation environment, once a company's share price declines, putative class representatives are easy to find (any shareholder will do); a large figure supposedly representing harms to a class of investors is easy to allege (the decline in share price multiplied by the relevant number of shares); a putative "fraud" is easy to articulate (fraudulently concealing whatever information prompted the decline in share price); and a willing lawyer is inevitably at hand. As this Court noted three decades ago, private securities actions "present[] a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739.

Public companies recognize that, unlike other class actions they might encounter from time to time, comparatively fewer abusive securities actions can be weeded out at the class certification stage. The requirement that a class be certified almost always poses a meaningful barrier to abusive litigation in the context of suits arising from a company's alleged misstatements made to customers, employees, or business partners. Most importantly, the substantive theories of recovery grounding such actions typically require class-wide proof of reliance—a requirement that frequently permits companies to contest successfully the class treatment of a plaintiff's claims. *See, e.g.*, *Castano v. American Tobacco Co.*, 84 F.3d 734 (5th Cir. 1996) (reversing certification of consumer class action based on concerns about the possibility of class-wide proof of

reliance on alleged misstatements); *Patterson v. Mobil Oil Corp.*, 241 F.3d 417 (5th Cir. 2001) (reversing certification of employee class action based on concerns about the possibility of class-wide proof of reliance on alleged misstatements); *Broussard v. Meineke Discount Muffler Shops, Inc.*, 155 F.3d 331 (4th Cir. 1998) (reversing certification of business tort class action based on concerns about the possibility of class-wide proof of reliance on alleged misstatements); *Heffner v. Blue Cross & Blue Shield of Ala.*, 443 F.3d 1330 (11th Cir. 2006) (reversing certification of ERISA class action because of concerns about the possibility of class-wide proof of reliance).

In stark contrast, companies defending abusive securities suits find themselves facing an onerous, often insurmountable, uphill battle. Under the "fraud-on-the-market theory," reliance is presumed when alleged misrepresentations purportedly impair the value of securities traded in an efficient market. Because misinformation to a market generally may affect a company's stock price, courts are willing to find injury even in the absence of direct reliance on, or even knowledge of, an allegedly fraudulent statement. *See, e.g., Basic Inc. v. Levinson*, 485 U.S. 224, 226, 235 n.12 (1988). Although the presumption of reliance is "rebuttable," *see id.*, overcoming the presumption is, in practice, very difficult and "hardly ever done." Jeffrey L. Oldham, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After The Private Securities Litigation Reform Act*, 97 Nw. U. L. Rev. 995, 1013 n.124 (2003).

Equally significant, damages in securities actions are initially calculated based on investors'

cumulative market losses, as opposed to the benefit a defendant may have derived from an alleged fraud. Based on this simple damages formula, plaintiffs typically seek astronomical recoveries that impose overwhelming pressures to settle. Accordingly, even when a complaint "by objective standards may have very little chance of success at trial," *Blue Chip Stamps*, 421 U.S. at 740, if the defendant does not win an early dismissal of the case, the "economics of litigation may dictate a settlement." S. Rep. No. 104-98, at 7 (1995).

Finally, as both legislative and judicial observers have noted, most securities litigation entails enormous discovery costs regardless of whether it is meritorious. *See* H.R. Rep. No. 104-50, at 15 (the costs of discovery in a securities class action will often push corporate defendants to "agree to a substantial settlement out of court"); *see also In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293, 1298 (7th Cir. 1995) (citing Henry J. Friendly, Federal Jurisdiction: A General View 120 (1973) (discussing the problem of "blackmail settlements")). Because large defendants have "warehouses full of files," litigants with weak cases are able to "heap" costs on their adversary and there is little that the corporate defendant can do to fight back. Frank Easterbrook, *Discovery As Abuse*, 69 B.U. L. Rev. 635, 636, 643 (1989); *Twombly*, 127 S. Ct. at 1967 (noting in a different context that "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases"). Even the least meritorious of cases have substantial settlement value because the "very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit." *Blue Chip Stamps*,

421 U.S. at 740 (citations omitted); *see also Merrill Lynch, Pierce Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510 (2006).

These dynamics, present to a large extent in all securities class-action litigation, would be greatly magnified if plaintiffs were permitted to impose large discovery costs and threatened liability on companies, like these defendants, with no participation or financial interest in the relevant sales of securities. In such circumstances, by merely alleging a class action, and without proving reliance, plaintiffs would have an open-ended ability to impose potentially overwhelming settlement pressures on tangential actors only remotely connected to an alleged fraud.

In a case such as this one, it will be the rare company that can withstand pressures to settle. Here, the damages alleged by plaintiffs, computed as the loss of value in Charter's stock from its class period high to its October 2002 low, total approximately $7 billion—although plaintiffs seem curiously abashed in mentioning this fact, which is omitted from their briefing. A rational businessperson defending this $7 billion case who has, say, 95 percent confidence of a win on the merits, will nonetheless settle so long as the proffered settlement costs $350 million or less—the expected price of a trial judgment involving a five percent chance of paying $7 billion. It is little wonder, then, that defendants in cases like this one, even cases of dubious merit, almost invariably resolve to silently grit their teeth, crucify their sense of fair play, and hold their collective noses, as they pay out undeserved dollars by the millions. Seldom

can securities class action defendants afford the high price of justice.

For the few defendants who do refuse to compromise, the costs can be dear. The attempts of a prominent plaintiff's firm to drive Lexecon, Inc. out of business, after it testified in support of a securities defendant, and Lexecon's ten-year battle to clear its name, provides a cautionary tale. *See, e.g.*, Melody Peterson, *Law Firm to Pay Longtime Foe $50 Million*, N.Y. Times, Apr. 4, 1999, at C2 (discussing jury verdict finding Nation's largest class-action plaintiffs' firm liable for abuse of process); *see also Lexecon, Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26 (1998) (describing history of litigation). As the recent indictment of the Milberg Weiss firm suggests, much securities class-action litigation over the last decade has been driven, not by securities investors, but by entrepreneurial lawyers and the national litigation industry they have come to embody. *See, e.g., U.S. Indictment for Big Law Firm in Class Actions*, N.Y. Times, May 19, 2006, at A1 (indicting class-action- securities firm with making more than $11 million in secret payments to individuals who served as plaintiffs in more than 150 lawsuit, generating $216 million in legal fees); *see also* Mukesh Bajaj, *et al.*, Securities Class Action Settlements: An Empirical Analysis, at 13 (Nov. 16, 2000) (Milberg Weiss accounted for 32% of all securities class-action settlements analyzed from 1988 to 1999). Justice Powell's concern, voiced 32 years ago, that "open-ended litigation" would "itself be an invitation to fraud" has proven remarkably prescient. *Blue Chip Stamps*, 421 U.S. at 761 (Powell, J., concurring).

B. Other Remedies Are Adequate to Protect Investors And Deter Fraud.

Notwithstanding Congress's efforts to curb securities litigation and its abuses in the Private Securities Litigation Reform Act of 1995, the last ten years have seen staggering increases in the costs of securities fraud suits and settlements.

The total dollar value of claims asserted in securities class-action lawsuits skyrocketed from approximately $150 million in 1997 to more than $9.6 billion in 2004. *See* Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn from London*, Wall St. J., Nov. 1, 2006, at A18. Moreover, the value of securities class action settlements in 2006 alone exceeded the total value of all settlements concluded from 1996 through 2005. *See, e.g.*, Laura E. Simmons & Ellen M. Ryan, Securities Class Action Settlements: 2006 Review and Analysis Cornerstone Research 1 (2007) ("*Securities Class Action Settlements*"); Michael R. Bloomberg & Charles E. Schumer, *Sustaining New York's and the U.S.'s Global Fin. Servs. Leadership*, at 74 (Dec. 2006) ("Bloomberg & Schumer Study"). Even excluding the massive Enron and WorldCom settlements, the value of cases settled in 2006 grew to some $10.6 billion, surpassing the previous yearly record, $3.5 billion in 2005, by more than 300 percent. *Securities Class Action Settlements*, at 1. Analysts estimate that, not including defense expenses, and amounts paid in SEC actions, fines, and penalties, American businesses paid more than $42 billion in securities class-action settlements between 1996 and 2006. *See id.* And one analyst reports that the "securities class action settlement

pipeline remains strong in 2007, with over $20 billion in tentative and pending settlements active in June." Institutional Shareholder Services, Securities Class Action Services, *at* http://www.issproxy.com/scas (last visited August 14, 2007).

Notwithstanding the extraordinary amounts of money changing hands, securities class litigation has provided no significant benefits to shareholders, nor has it deterred fraud. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 Colum. L. Rev. 1534, 1535-36 (2006) (securities class actions inevitably "produce wealth transfers among shareholders that neither compensate nor deter"). Settlement amounts are largely untethered to a defendant's ascertained culpability or the benefits it may have received as a result of its allegedly fraudulent conduct. Rather, the size of a settlement is invariably driven by the size of the defendant's ability to pay. For these reasons, the deterrent effects of large class action payouts is minimal.

Although most securities class suits settle for only a very small percentage of each investors' alleged losses, a large percentage of overall settlement amounts are pocketed by plaintiffs' attorneys. *See, e.g.*, Janet C. Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1503 (1996) ("payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up"). This means that of the more than $42 billion in settlements from 1996 to 2006, as much as $10 to $20 billion went to pay for legal fees. *Cf.* Bloomberg & Schumer Study, at 1.

More fundamentally, because public companies are owned by the investing public, virtually all of the costs of a modern securities class-action lawsuit fall on the corporation and its insurer and, therefore, are ultimately borne by the defendant corporation's shareholders. *See Interim Report of the Committee on Capital Markets Regulation*, at 78, 71 (Nov. 30, 2006) ("*Interim Report*"); *see also* Coffee, *Reforming the Securities Class Action*, 106 Colum. L. Rev. at 1538 ("securities litigation imposes costs on investors because of harm done to investors—without recognizing that the victim is ... bearing the costs of its own injury"). Because a securities class action is a suit by shareholders victimized by fraud against shareholders who happen to own the company at the time the suit is brought, "shareholders, and particularly institutional investors," are often "on both sides." *Interim Report*, at 11. Investors are always "the ultimate losers when extortionate 'settlements' are extracted" in class-action securities litigation. *Id.* Empirical data suggest that the mere filing of securities litigation decreases the equity value of the defendant company; in fact, it is estimated that at least "$24.7 billion in shareholder wealth" has been wiped out due to litigation. Anjan V. Thakor, *The Unintended Consequences of Securities Litigation*, at 14 (U.S. Chamber of Commerce Institute for Legal Reform 2005).

Given the exponential growth in securities class-action litigation, the Court should be especially wary of petitioner's invitation to impose liability on vendors with no participation or financial interest in the relevant securities market activity. The investor losses that purportedly concern Stoneridge and its *amici* are much more appropriately addressed

through enforcement mechanisms other than private securities class actions—mechanisms that pose far fewer risks of picking the pockets of investors they were established to protect.

For example, Congress has given the SEC numerous statutory and administrative tools for preventing and punishing fraud. The SEC may obtain injunctive relief, issue administrative orders, and impose large civil penalties, including disgorgement remedies, on any companies engaged in or aiding and abetting fraud. *See, e.g.*, 15 U.S.C. §§ 78u, 78u-3. Exercising this authority in fiscal year 2006, the Commission initiated 914 investigations, 218 civil proceedings, and 356 administrative proceedings. *See U.S. Securities and Exchange Commission: 2006 Performance and Accountability Report*, at 8 (2006). In that same year, the Commission recouped more than $3.3 billion in disgorgement and other penalties. And over the last five years, it has recouped a total of approximately $8 billion for distribution to harmed investors. *See id.*

Other government entities have likewise responded with vigor to securities-related fraud. The Department of Justice's Corporate Fraud Task Force, created in 2002, has as its mission restoring "public and investor confidence in America's corporations following a wave of major corporate scandals." Department of Justice, *Fact Sheet: President's Corporate Fraud Task Force Marks Five Years of Ensuring Corporate Integrity* (Jul. 17, 2007). Since its inception, the Task Force has "compiled a strong record of combating corporate fraud and punishing those who violate the trust of employees and

investors," obtaining 1,236 corporate fraud convictions as of July 17, 2007. *See id.* Similarly, the Department's Asset Forfeiture and Money Laudering Section has obtained more than $1 billion in fraud-related forfeitures, which it has distributed to victims of fraud. *See id.*

II. Expansive Liability Discourages Foreign Companies From Investing In United States' Public Markets.

In addition to harming investors, securities class-action abuse reduces the overall competitiveness of United States securities markets, as fear of potential liability discourages foreign companies from listing on American stock exchanges. *See Common Sense Legal Reform Act: Hearings on H.R. 10 Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Commerce*, 104th Cong., 1st Sess. 221, 224 (1995) (statement of former SEC Chairman Richard C. Breeden) (based "on conversations with potential issuers of securities all over the world, the fear of litigation inhibits foreign firms from participating in the U.S. market[s]"). Vague, unpredictable, and expansive liability rules harm the financial services sector and deter foreign investment.

Like many parts of the economy, the financial services sector "has become increasingly subject to the forces of globalization and international competition." Bloomberg & Schumer Study, at 31; *see also id.* at 39. The United States historically has had the deepest, most liquid, financial markets in the world. But, as technology has eliminated barriers to the flow of capital, investors have increasingly focused on competitive differences

between markets. The United States can "no longer take" its "preeminence in the financial services industry for granted." *Id.* at i ("if we do nothing, within ten years ... we will no longer be the financial capital of the world").

A leading indicator of the competitiveness of the United States public equity markets is their ability to attract listings of foreign companies engaged in initial public offerings ("IPOs"). *See Interim Report*, at 29; *see also* Bloomberg & Schumer Study, at 43 (IPOs "are the first in a series of events that generate substantial recurring revenues for the host market"). By that measure, the United States' markets' recent performance is disturbing. From 2000 to 2005, the percentage of global IPOs listing in the United States declined from 37 percent to 10 percent. *See Interim Report*, at 29; *see also* Bloomberg & Schumer Study, at 43 (in 2006, U.S. exchanges captured one-third of the amounts captured in 2001). In sharp contrast, the global share of IPO volume "captured by European exchanges has expanded by more than 30 percent over the same period, while non-Japanese Asian markets have doubled their equivalent market share since 2001." Bloomberg & Schumer Study, at 43. In short, whether considering the relative percentage of global IPOs taking place on U.S. exchanges, or the relative value of those offerings, "the U.S. exchanges are rapidly losing ground to foreign rivals." *Id.*

The decline of the U.S. public exchanges in an increasingly international market is closely tied to the growing global perception of the United States' legal system as costly and unpredictable. *See* Bloomberg & Schumer Study, at 16; *see also* Ian

Swanson, *Foreign Executives Press for Reform of Litigation in the United States*, The Hill, May 17, 2007. Notwithstanding recent efforts to "curb class action abuses, such lawsuits are still viewed by foreign investors as sources of significant uncertainty." Robert E. Litan, *Through Their Eyes: How Foreign Investors View and React to the U.S. Legal System*, at 14 (Aug. 2007); *see also* Survey, *Obstacles to TransAtlantic Trade and Investment*, at 11 (June 2005) ("legal liabilities or the fear of legal action ... deters European companies from doing business in/with the United States").

In fact, numerous studies and reports have found that the "United States is losing its leading competitive position as compared to stock markets and financial centers abroad" in part because of expanding "liability risks." *Interim Report*, at ix, x. Foreign companies are "staying away from U.S. capital markets for fear that the potential costs of litigation will more than outweigh any incremental benefits of cheaper capital." Bloomberg & Schumer Study, at 101. As Paul S. Atkins, an SEC Commissioner, recently emphasized, "abusive class actions that result in few or imaginary benefits for class members, but for which large cash fees are paid to plaintiffs' attorneys," are a significant problem that "add to the global perception that the U.S. legal system operates as a 'lottery-like' system of justice." Speech by Comm'r Paul S. Atkins, *Is Excessive Regulation and Litigation Eroding U.S. Financial Competitiveness* (Apr. 20, 2007). United States' "businesses are now being subjected to various class actions that previously would have ... been thought laughable." *Id.* The liability risks that even these "laughable" actions entail are "driving growing

international concern about participating in U.S. financial markets." Bloomberg & Schumer Study, at 16.

The large difference in the hard-dollar costs entailed by litigation risks in the United States as opposed to other markets is undeniable. In 2004, for example, private securities class actions in this country resulted in $3.5 billion in liability, and civil penalties amounted to an additional $4.74 billion. *See Interim Report*, at 11, 71. In contrast, in the United Kingdom, penalties for all financial sectors during the same period totaled a mere $40.48 million. *Id.* Reflecting these differences, the price of Directors and Officers' insurance in the United States is six times the cost of comparable insurance in Europe. *See id.* at 71, 78. Overall, "gross financial regulatory costs" are approximately 15 times larger in the United States than in Britain. *See* Schumer & Bloomberg, *To Save New York*, at A18.

Even beyond actual litigation costs, it has become increasingly clear to international investors that the mere threat of legal action in the United States can destroy a company. *See* Bloomberg & Schumer Study, at 76; *see also* Timothy Shipman, *Stoneridge Court Case Threatens Trade With US*, Sunday Telegraph, Jul. 7, 2007 ("British companies that conduct business in the United States or do deals with American companies could find themselves sued for billions of dollars"). The number of companies hobbled, forced into bankruptcy, or even liquidated in response to the threat of securities-related litigation, has reinforced the international perception of the United States legal system as unpredictable,

unfair, and unnecessarily punitive. *See* Bloomberg & Schumer Study, at 76.

III. Because The Vendors Entered Arm's-Length, Non-Financial Transactions, They Should Not Be Subjected To Expansive Liability.

Congress enacted the PSLRA because it recognized the problems of expansive liability and wanted to provide a "check against abusive litigation by private parties." *Tellabs*, 127 S. Ct. at 2504; *see also* H.R. Rep. No. 104-369, at 31 (1995) (noting the PSLRA was intended to curb perceived abuses of the section 10(b) private action). Instead of heeding calls for the restoration of private aiding-and-abetting liability, Congress sought to "remov[e] the plaintiffs' class action bar from the equation" by granting the Securities and Exchange Commission, but not private litigants, the authority to prosecute aiders and abetters who provide "substantial assistance" to those engaged in fraud. 4 Bromberg & Lowenfels, Securities Fraud & Commodities Fraud § 7:308, at 7-506 (2d ed. 2006).

Stoneridge and its *amici* nonetheless insist that, at least in cases of established fraud, there might well be instances (and they insist this is one) where actors such as accountants, lawyers, underwriters, bankers—and vendors—are so integrally intertwined in fraudulent conduct that they deserve to bear the brunt of private class litigation, however onerous that may be. *See* Stoneridge Br. at 36 (describing hypothetical situation in which attorney allegedly should be subject to securities law liability); AARP Br. at 3 (arguing for imposing liability on "accountants, bankers, lawyers, and others who are

not affiliated with the corporate issuer but who actively scheme with the issuer"); Br. of Ohio *et al.*, at 4-5 (arguing in favor of imposing liability on "unprincipled accountants, lawyers, and banks, as well as unscrupulous vendors").

An obvious problem with these arguments is that they obscure the question presently at issue by focusing on *other* types of secondary actors that might be sued in *other* types of cases. This case does not involve some faithless fiduciary or scheming capital-provider. It involves two vendors engaged in arm's-length sales of ordinary goods and services. Whatever issues tomorrow may bring, as the Eighth Circuit correctly recognized, there is and can be no claim that Scientific-Atlanta and Motorola occupy a fiduciary position with respect to Charter or its shareholders. *See In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (reasoning that the vendors were not "under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition"). And there also can be no claim that Scientific-Atlanta or Motorola invested their own capital in Charter and then schemed with management to protect or enhance that investment. All questions of liability standards for attorneys, accountants, other professionals, and unscrupulous capital providers can therefore await another day.

In contrast to petitioner's subjective and conveniently malleable "purpose and effect" standard, *see, e.g.*, Stoneridge Br. at 14-15, the Eighth Circuit's legal test involves a pair of inquiries that yield final, predictable, and just outcomes in thousands of real-world situations. *First*, did the

"business transaction" between a securities issuer and its alleged co-principal involve sales of ordinary goods and services, as opposed to the provision of capital or professional services used to obtain capital? *See* 443 F.3d at 992 (focusing on whether a transaction involved "goods and services other than securities"). *Second*, assuming the dealings involved ordinary goods and services, were the relevant sales concluded at "arm's length," in the sense that they occurred between entities not maintaining cross-holdings or other interests in one another's securities and not under common ownership? *See id.* As the Eighth Circuit recognized, satisfying both prongs of this test should be sufficient (although not necessary) to obtain a suit's dismissal under the securities laws. Where, as here, both prongs are met, dismissal is in order and the risk of vexatious litigation is eliminated. *Id.*

The fact that these two vendors' dealings with Charter are accurately described as an "arm's-length" vendor-buyer relationship involving "goods and services other than securities" is dispositive with respect to whether a federal *securities* fraud may have occurred. *See* 443 F.3d at 992. To violate section 10(b), a party must use or employ a manipulative or deceptive device "in connection with the purchase or sale" of any security. 15 U.S.C. § 78j(b) (2006). The Congress that enacted section 10(b) intended to target "unfair practices in speculation"—that is, practices engaged in by market actors in connection with the purchase or sale of securities. *See* S. Rep. No. 73-792, pt. II.4 (1934). Congress paid particular attention to practices such as stock pools, "wash" sales, stock price manipulation by market specialists, short sales, market letters,

and paid propaganda, because each of those practices involved transactions among market actors acting as such or conduct directed at the securities markets. *See id.*; *see also* S. Rep. No. 73-1455, pt. I.7, at 26-50 (1934). In short, the Securities Exchange Act sought "to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges." H.R. Rep. No. 73-1383, at 2. The drafting history of section 10(b) thus confirms what its plain language makes clear: Congress did not intend for section 10(b) to impose liability for all securities market reverberations of all common fraud, but only to impose liability for frauds committed "in connection with" purchases and sales of securities.

Against this backdrop, this Court has, quite properly, been willing to find fraudulent behavior sufficiently "connect[ed] with the purchase or sale of any security" only where (i) the violating party directly purchases or sells securities, or (ii) the fraudulent or deceptive behavior "coincides" with the purchase or sale of a security. *SEC v. Zandford*, 535 U.S. 813, 819–20 (2002). By interpreting the "in connection with" requirement of section 10(b) as limiting liability only to those actors who themselves deal in securities or have a stake in others' dealings in securities (such as parties making disclosures, owing fiduciary duties to investors, engaging in insider trading, or otherwise acting in the public markets), the Court has properly respected Congress's decision to focus on wrongful conduct occurring in securities markets. *See Blue Chip Stamps*, 421 U.S. at 733-34 & n.5 (the "in connection with" requirement is "badly strained" when

construed to cover "the world at large"). There is not a shred of evidence in section 10(b)'s text or drafting history suggesting that it was intended to reach ordinary, arm's-length commercial transactions, even fraudulent transactions, engaged in with a securities issuer.

Stoneridge responds to the Eighth Circuit's analysis by subtly taking issue with its labeling of the vendors' dealings as "arm's length business transactions in goods or services other than securities." 443 F.3d at 992; *see* Stoneridge Br. at 14 ("This is not a case involving an 'arm's length transaction' in which a party acted honestly but perhaps with knowledge that the transaction would mislead investors."). But, of course, the probity or dishonesty of those participating in a transaction has nothing to do with whether the transaction is concluded at "arm's length." Black's Law Dictionary 116 (8th ed. 2004) (arm's-length transactions involve "dealings between two parties who are not related or on close terms"). So long as two parties are "not related," party A can sell party B the Brooklyn Bridge in an "arm's length" (albeit utterly fraudulent) transaction. Accordingly, in commercial contract, fraud, and negligence cases, courts have long recognized that parties who enter arm's-length transactions do so without forming a "confidential relationship," and that such transactions do not create "fiduciary duties between the parties." *Id.*; *see also Schulist v. Blue Cross of Iowa*, 717 F.2d 1127, 1132 (7th Cir. 1983) (no fiduciary relationship arises when parties transact at arm's length).

Stoneridge's more vigorous contention is that the Court should read the "in connection with"

requirement out of section 10(b) because to enforce that requirement would be to teach companies "that they can get away with fraud." Stoneridge Br. at 35. Stoneridge contends that expanding section 10(b)'s reach beyond its plain terms is essential because otherwise "a logistics company could hide inventory for customers during audits"; or a "testing lab could, for a fee, provide false 'proof' that a new invention worked or that a new drug was effective or safe." *Id.* at 36. But even if all this were true (and it is not), the Court still would have no warrant to overlook important limitations enacted by Congress. *See, e.g.*, *United States v. National Ass'n of Securities Dealers, Inc.*, 422 U.S. 694, 720 (1975) (Court is bound by statutory limitations defined by Congress). Securities actions are a class litigation vehicle of choice for plaintiffs' attorneys precisely because they offer almost limitless opportunities for imposing discovery costs, favorable methods for toting up damages, relatively easy methods for establishing reliance, and other attractive features. To disregard express limitations on the employment of this vehicle of choice would expand section 10(b), without warrant, beyond its intended scope.

In truth, the prospect of companies escaping liability after committing Stoneridge's hypothetical horribles is just that—entirely hypothetical. Criminal and civil sanctions for fraud were fixtures in Anglo-American jurisprudence for centuries before the Securities Act of 1933 and the Securities Exchange Act of 1934, and remain so today. *See, e.g.*, 3 William Blackstone, Commentaries on the Laws of England 431 (1768) ("[I]t hath been said, that fraud, accident, and trust are the proper and peculiar objects of a court of equity. But every kind of fraud

is equally cognizable, and equally adverted to, in a court of law."). Accordingly, the fact that a company may be immune from prosecution for *securities* fraud does not mean it is immune from prosecution for mail fraud, wire fraud, common law fraud, or the many other species of fraud the law prohibits. *See, e.g.*, 18 U.S.C. § 1341 (2002) (criminalizing mail fraud); *id.* § 343 (criminalizing wire fraud). In this case, as in the Stoneridge hypotheticals outlined above, there clearly was no fraud by vendors in connection with the purchase or sale of *securities*; hence, no *securities* fraud can properly be alleged.

A bright line recognizing that ordinary commercial transactions fall outside the federal prohibition of *securities* fraud is in the long-term interest of all investors. Companies engaged in ordinary business should be able to know in advance what will and will not expose them to the securities laws' potentially devastating liabilities. Fudging this line, by holding companies potentially liable for securities frauds committed by their arm's-length business partners, would pull companies in conflicting directions by forcing them to choose between, on the one hand, serving the interests of their own shareholders by entering into favorable transactions that enhance corporate wealth; and, on the other hand, declining to enter arm's-length transactions where there is some unquantifiable risk of being accused of complicity in someone else's fraud.

Finally, Stoneridge contends in passing that extending securities law liability to arm's-length vendors does not unduly risk outsized liability because, in the wake of the Private Securities

Litigation Reform Act, the securities laws now limit liability to amounts proportionate to fault. *See* Stoneridge Br. at 16 ("Congress imposed a system that made each actor responsible only for its proportionate share of damages absent a knowing violation."). This provision for proportionate liability is cold comfort, however, to parties like these defendants who bear only attenuated responsibility for potentially enormous losses. The most telling aspect of Stoneridge's briefing may well be its complete omission of any mention of the $7 billion potential damages entailed by the Charter stock drop. Stoneridge accounts almost to the penny for the $17,530,000 by which Scientific-Atlanta and Motorola allegedly inflated their invoices to Charter. *See* Stoneridge Br. at 8. And Stoneridge further contends that this $17,530,000 in "free" advertising actually may have been worth only one-fifth as much, or perhaps $3,506,000. *Id.* at 11. But by failing to mention any estimate of the Charter investors' total losses, Stoneridge effectively turns a blind eye to the very troubling *ratio* between these figures—the fact that the defendants' supposed receipt of some $3.5 million worth of undeserved free advertising has prompted their joinder in a suit in which claimed damages may well approach $7 billion, or 2,000 times as much.

Nor can these defendants find solace in the fact they might someday have an opportunity to contend that they should be held responsible for only a small share of an allegedly gigantic loss. If held responsible for *only one percent* of $7 billion, the defendants are in line for liability equal to $70 million or approximately 20 times the supposed value of the supposedly ill-gotten benefit they

received. Moreover, proportionate liability, while it can reduce the upper bound on a defendant's exposure, can make the imposition of that lesser liability more likely by inviting triers of fact and other decisionmakers to spread the blame and attendant pain. Proportionate liability, in this context, is not an effective antidote to the problem of litigation abuse; rather, it is a further example of the type of subjective and open-ended liability rule that invites plaintiffs to seek the deepest possible pockets into which they can dive for litigation riches.

As the Court has recognized in a different context, "[d]eciding what competing values will or will not be sacrificed to the achievement of a particular objective is the very essence of legislative choice." *Rodriguez v. United States*, 480 U.S. 522, 526 (1987). It "frustrates rather than effectuates legislative intent simplistically to assume" that more liability is inevitably better than less. *Id.* Here, Stoneridge assumes "simplistically" that more securities law liability is always better, even for equipment makers that dealt in set-top boxes, not stocks and bonds. Whatever penalties may or may not be warranted for the alleged actions of these defendants, assuming Stoneridge's allegations can be proven, those penalties certainly should not include an enormous potential liability for losses incurred by Charter's investors.

CONCLUSION

For these reasons, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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August 15, 2007

IN THE SUPREME COURT OF THE UNITED STATES

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner
v. : No. 06-43
SCIENTIFIC-ATLANTA, INC., ET AL.

Washington, D.C.
Tuesday, October 9, 2007

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:00 a.m.

APPEARANCES:

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STEPHEN M. SHAPIRO, ESQ., Chicago, Ill.; on behalf of Respondents

THOMAS G. HUNGAR, ESQ., Deputy Solicitor General, Department of Justice, Washington, D.C.; on behalf of the United States, as amicus curiae, supporting Respondents.

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P R O C E E D I N G S

(11:00 a.m.)

CHIEF JUSTICE ROBERTS: We'll hear argument next in Case 06-43, Stoneridge Investment Partners v. Scientific-Atlanta et al.

Mr. Grossman.

ORAL ARGUMENT OF STANLEY GROSSMAN

ON BEHALF OF THE PETITIONER

MR. GROSSMAN: Thank you, Mr. Chief Justice, and may it please the Court:

The text of Section 10(b) as well as the Rule 10b-5 promulgated by the Securities and Exchange Commission prohibit the use of any deceptive device by any person, indirectly or indirectly, in connection with the purchase or sale of a security. The various deceptive devices used by the Respondents in this case is conduct that is squarely covered by the text of the statute and by the rule.

Respondents here were not passive bystanders facilitating a fraud by Charter. Their deceptive conduct was integral to the scheme to create fictitious advertising revenues for Charter to report to investors.

Respondents agreed to overcharge Charter so that they could receive the money from Charter to then return to it for the advertising, using Charter's very

same money for the purchase of the advertising. Respondent Scientific-Atlantic created a document falsely claiming that the reason for the increased payments from Charter were because of increased manufacturing expenses.

JUSTICE KENNEDY: The transaction was not wholly without benefit to Scientific-Atlantic. They got some advertising. And it was not wholly without benefit to Charter. They were able to show that advertising works. Now, that puts aside the fact that they were using misleading accounting principles.

MR. GROSSMAN: Well, I would agree, Your Honor, that they received free advertising. But the problem was that they were creating the illusion that it wasn't free advertising, but rather that they were purchasing the advertising.

JUSTICE GINSBURG: And was the price four to five times higher than the normal rates for advertising?

MR. GROSSMAN: That is correct, Justice Ginsburg.

And the obvious purpose for creating the illusion that they were purchasing the advertising rather than receiving free advertising was so that Charter can incorporate these increased revenues in their financial statements. And Respondents understood,

they understood that in order to, for Charter to pass this by their accountants, to deceive the accountants -- and this is reflected in the indictment -- in order to deceive the accountants for Charter, the Respondents were told that there had to be separate agreements for both the advertising agreements and the purchase agreements.

JUSTICE SCALIA: Mr. Grossman, is there any reason why, in principle, the elements for a cause of action under 10b-5 have to be the same as the elements for a cause of action by the agency under 10b? I mean, we, we created this, this cause of action. It's not set forth in the statute, although other private causes of action are.

If it's our creation, couldn't we sensibly limit it so that, for example, schemes can be attacked by the SEC, but schemes do not form the basis for private attorney general's actions? You need actual conveyance of a misrepresentation to the injured party. Is there any reason why we couldn't do that?

MR. GROSSMAN: Well, I think there are two reasons, Your Honor. The first is that at this point in time -- I think as the Court recognizes in Dura fairly recently, that when Congress enacted the Private Security Law Reform Act, that at that time they accepted

the private right of action that this Court had previously inferred. And this Court had previously inferred the private right of action not only for the section but each of the rules in Section 10(b).

CHIEF JUSTICE ROBERTS: But it's not like under the Sherman Act, where we have reason to think Congress intended the Court to go about the business of construing and developing antitrust law. In fact, they are kind of taken over for us. They are imposing certain limits on when actions can be brought, proposing specific elements. In one of the provision, 20(e), specifying SEC can bring an action but private investors can't.

I mean, we don't get in this business of implying private rights of action any more. And isn't the effort by Congress to legislate a good signal that they have kind of picked up the ball and they are running with it and we shouldn't?

MR. GROSSMAN: Well, this Court, Your Honor, as recently as 2002 in Wharf (Holdings) said there is a private right of action for violation of any of the subdivisions of Rule 10b-5: A, B, or C. That would have to be reversed.

Going back to the Superintendent of Insurance case in, in -- that would be in 1971, Your

Honor, the Court held there was a private right of action for violation of --

CHIEF JUSTICE ROBERTS: Well, that's kind of my point. We did that sort of thing in 1971. We haven't done it for quite sometime.

MR. GROSSMAN: Well, when Congress enacted the Private Security Law Reform Act, everything it did in connection with that statute was directed to the private right of action that this Court had previously implied under 10(b). Nothing that Congress did was intended in any way --

CHIEF JUSTICE ROBERTS: I'm not -- my suggestion is not that we should go back and say that there is no private right of action. My suggestion is that we should get out of the business of expanding it, because Congress has taken over and is legislating in the area in the way they weren't back when we implied the right of action under 10(b).

MR. GROSSMAN: I would agree, Congress has taken over. When they enacted the Private Security Law Reform Act, they recognized this private right of action. Everything they did recognized the private right of action. It recognized that there would be multiple primary violators of 10(b). It did that in connection with proportionate liability provisions. It

recognized that there would be multiple players.

So certainly, Congress had an understanding of what this Court had done up until that time. And this Court up until that time had implied the private right of action for every subset of Rule 10b-5.

CHIEF JUSTICE ROBERTS: Is it -- is it a necessary part of your theory that the deceptive practice that Scientific-Atlantic went in, that they knew that that was also -- that Charter would carry that forward? I mean, let's suppose that there were benefits to this deceptive practice to Scientific-Atlantic, that it looked like it had more money to spend on advertising than it really did, but they didn't care what Charter did with it. In fact, they didn't know that Charter was going to carry it on its books the way they did. Would there still be liability for Scientific-Atlantic?

MR. GROSSMAN: No. No, not under the test that we have proposed, which is very similar to the test proposed by the Ninth Circuit or applied in the Ninth Circuit in the Simpson case, and the test proposed by the Securities and Exchange Commission in their amicus brief submitted in the Simpson case. It's not enough just to have the deceptive act. The deceptive act for scheme liability has to be with the purpose of furthering a scheme to defraud its investors.

So if Scientific-Atlanta or Motorola had engaged in deceptive conduct, but that deceptive conduct was not intended to further a scheme to defraud the shareholders, no, Your Honor, there would be no action under the theory that we are pursuing here.

JUSTICE SCALIA: Intended or known? I mean, I don't see -- what's in it for Scientific-Atlantic to defraud the shareholders? Is it enough that they just knew it would be used for that purpose?

MR. GROSSMAN: Oh, it would be enough if they committed a deceptive act and they knew it was in furtherance of a scheme.

JUSTICE SCALIA: Well, when you say "in furtherance of," you -- you import intent. They didn't care what Charter was going to do with it, but they pretty well knew that what Charter was going to do was to make its books look better.

Would that be enough?

MR. GROSSMAN: I think that would be reckless.

JUSTICE SCALIA: That's what I thought your position was.

MR. GROSSMAN: Yes, but my position is also --

JUSTICE SCALIA: Not an intent necessarily.

It's just knowledge.

MR. GROSSMAN: You certainly needs scienter. You certainly need scienter.

JUSTICE SOUTER: It's more than knowledge. You mentioned recklessness. It's got to have either knowledge of or a willingness to maintain indifference to the consequence.

MR. GROSSMAN: Exactly right, Justice Souter. And I think it's important -- and there is, there is a very good discussion of this in the Simpson case by the Ninth Circuit, that the purpose of the test is such that it will not ensnare someone who does engage in a deceptive act but doesn't understand that the reason for it is to further a scheme.

JUSTICE SCALIA: Sure. After trial -- you know, after trial which causes your stock to tank, you may indeed be able to show that you didn't know it was going to be used for that purpose. I mean, that's what this is all about, isn't it, getting it -- getting it by the summary judgment stage?

MR. GROSSMAN: No. I think, Your Honor, that this Court answered this last term in the Tellabs case. And Congress answered that question that you pose in the PSLRA, the Private Security Law Reform Act, so that you cannot just bring a case and hope to get it by

the summary judgment stage. You have to have particularized facts alleged under the heightened pleading standards of the PSLRA and this Court's decision in Tellabs showing that not only the deceptive act, but that the purpose of that deceptive act was to further a scheme. So, no, you can't~--

JUSTICE SCALIA: What facts -- what has to be alleged short of -- on information and belief the Defendant knew that -- that this information would appear on the balance sheets and be used to improve the status of the stock?

MR. GROSSMAN: Well, of course if you just -- if you just allege it on information and belief, you're out of court. No doubt about that. That doesn't pass the heightened pleading standard in Tellabs and the PSLRA. What you do need is what we have here. Here you have allegations -- and we didn't make these allegations from whole court -- these allegations were derived principally from the grand jury -- the Federal grand jury indictment against Charter executives. That indictment says that Respondents were informed and ordered to deceive Charter's accountants. They had to have --

CHIEF JUSTICE ROBERTS: Why shouldn't we be guided by what Congress did in the action to the Central

Bank case? There we said there's no aiding and abetting liability, Congress amended the statute in 20(e) to say yes, there is, but private plaintiffs can't sue on that basis. Why shouldn't that inform how we further develop the private action under 10b-5?

MR. GROSSMAN: Well, I think if Congress intended under 20(e) -- certainly the private action is similar to this -- it would have said that only the SEC has the authority to bring a claim for substantial assistance whether or not it involves deceptive conduct. They could have very easily said any deceptive conduct, and that would have barred these claims. They chose not to do that.

CHIEF JUSTICE ROBERTS: But they were -- they were addressing a very specific decision from this Court, the Central Bank decision. And the one thing they did not do was say that that decision was wrong with respect to private -- or going forward they weren't going to overrule that decision with respect to private rights of action. You're asking us to extend to non -- I know you call it a primary violator, but not the person who --

MR. GROSSMAN: Secondary actors.

CHIEF JUSTICE ROBERTS: -- who put the deceptive conduct into the market. You're asking us to

extend that liability to, them which seems inconsistent with Congress' approach in 20(e).

MR. GROSSMAN: We are not asking any extension. Quite the contrary, Your Honor. I think that's the Respondents who are asking for narrowing. When Congress addressed the PSLRA it addressed all of the arguments that we are hearing today from Respondents and their amici.

JUSTICE ALITO: Is your theory dependent on the proposition that Scientific-Atlanta and Motorola deceived Arthur Andersen?

MR. GROSSMAN: That certainly is a large part of it. Yes, Your Honor.

JUSTICE ALITO: But didn't you allege exactly the opposite in your complaint?

MR. GROSSMAN: No. We -- I think what you're referring to is that -- is that the accountants should have conducted a more diligent audit than they did. I mean these people clearly were trying to deceive the auditors. Why else would you wish you would document falsely stating a reason for a price increase?

JUSTICE ALITO: Well, I'm looking at paragraph 218 of your amended complaint, 109 (a) of the joint appendix, subsection 4. It says, speaking of Arthur Andersen, "though aware that Charter was seeking

to boost its revenues by paying vendors higher prices at the same time it received additional advertising from the same vendors, Andersen failed to properly audit these transactions by confirming them with the vendors." You alleged that they weren't deceived. You alleged that they knew exactly what was going on.

MR. GROSSMAN: No -- no, Your Honor, they knew that they were paying the vendors higher prices, but they didn't know why. The contract -- the contract for the higher prices was followed by this misstatement saying the reason for the higher prices is because of increased manufacturing expenses, when in fact that wasn't the reason. The reason was to take money --

JUSTICE GINSBURG: Who told -- who told Charter that it was necessary for them to have a time spread between the contract -- the $20 above the contract price and the advertising payment?

MR. GROSSMAN: Arthur Andersen.

JUSTICE GINSBURG: Well, if it told them that, didn't it have -- it sounds to me from that if the accountant says, look, if you want to make this appear on the balance sheet as though the advertising revenues were just ordinary advertising revenues, you better separate these two. I suggest that Arthur Andersen knew all along what was going on.

MR. GROSSMAN: No. Justice Ginsburg, what Arthur Andersen did not know -- and this is very clear. They did not know that it was Charter's own money that was being used by the Respondent to purchase the advertising. They were deceived by that document that said, we are increasing the price on the set-top boxes because of increased manufacturing expense. That was false. The reason they were increasing it is because Charter was delivering the money to them.

JUSTICE SCALIA: But that's exactly the thing they told them to separate.

MR. GROSSMAN: Well, not for that reason, Your Honor.

JUSTICE SCALIA: What other reason?

MR. GROSSMAN: The reason is as follows. This is what they refer to as barter contracts, two companies exchanging things, which is perfectly legitimate, nothing wrong with that. And there are certain ways to account for it properly, and what Arthur Andersen was telling Charter was in order to be able to have revenues included, gross revenues, you have to have unrelated -- unrelated contracts. They couldn't be a barter transaction. But there is no way -- no way that you could recognize the advertising revenues if you're using Charter's own money, and that's what Arthur

Andersen did not do. It would be no different, Justice Scalia, if Charter delivered a suitcase filled with cash and gave it to them and said okay, buy the advertising from us.

JUSTICE SCALIA: I understand what you're saying. It seems to me that when you say that they can't be connected, you're saying precisely, you can't be bartering the advertising revenue for the increased money that you're paying.

MR. GROSSMAN: No. You can barter. You can barter, it's just a question of how you account for it. But the bartering is one thing. I mean, that's one accounting principle relating to bartering, but there is no accounting principle that permits the recording of revenue if you're using the money from the seller. And that's why they discussed --

JUSTICE ALITO: All right, just to be clear on this -- just to be clear on this -- if Charter and Arthur Andersen and Scientific-Atlanta and Motorola all sat down and cooked up this scheme together and they all knew exactly what was going on, would you have a claim against the Respondents here?

MR. GROSSMAN: Yes. And the reason for that, Your Honor, is because the advertising contract was a sham, and the advertising contract was a sham

because Charter was giving the Respondents money to buy the advertising.

JUSTICE ALITO: Then I see absolutely no difference between your test and the elements of aiding and abetting.

MR. GROSSMAN: The difference is conceptual.

JUSTICE ALITO: Because you said it's not necessary for there to be an actual deceptive act on the part of the Respondents.

MR. GROSSMAN: There has to be a deception -- there is deception. The deception is you're entering into an advertising contract that presents the illusion that you were purchasing advertising, when in fact you were not purchasing advertising.

CHIEF JUSTICE ROBERTS: But that's -- but that's not the fraud that was imposed upon the market. The fraud imposed upon the market was Charter's accounting for the transaction on its books. Nobody bought or sold stocks in the reliance upon the way that Scientific-Atlanta and Charter structured their deal. They did so in reliance upon the way Charter communicated its accounting to the marketplace.

MR. GROSSMAN: There was no way -- no way that that could properly be accounted for, and the Respondents understood that. And that's why they did

what they did, that's what --

JUSTICE KENNEDY: But there are -- there are any number of kickbacks and mismanagements and petty frauds that go on in the business, and business people know that any publicly held company's shares are going to be affected by its profits, so I see no limitation to your -- to your proposal for validly.

MR. GROSSMAN: Well, I think the limitations are as follows, Your Honor. Number one, there has to be the purpose of furthering a scheme to defraud shareholders. Number two, the test has an element of materiality, that it cannot be --

JUSTICE KENNEDY: Well, I agree with Justice Scalia's earlier comment, I don't think that Scientific-Atlanta or Motorola really cared anything of -- one way or the other about the investors. For them the scheme made a certain amount of sense, they didn't really care.

MR. GROSSMAN: They may not have cared, but that would be reckless because they certainly understood --

JUSTICE KENNEDY: But that's far different from having a purpose. You said they have to have a purpose.

MR. GROSSMAN: That's correct. If you just

close your eyes -- if somebody comes to you and says, look, we want you to enter into this transaction, it's a phony transaction and we don't care -- do whatever you want with that, and they know it's a publicly held corporation and they have every reason to understand that this information --

JUSTICE KENNEDY: Which goes back to my earlier question -- that most people that engage in frauds on business know that if it's a publicly held corporation, it's going to hurt the price of the shares or affect the price of the shares.

MR. GROSSMAN: Well, they shouldn't engage in schemes to defraud, that's what Congress intended by Section 10.

JUSTICE SOUTER: But as I understand your argument, it is the difference between the aiding and abetting liability on the part of the Respondents and liability is, in effect, as first line principles, is their intent, or at the very least in knowledge that they were committing a deceptive act as part of this scheme. Is that correct?

MR. GROSSMAN: That they have to commit the deceptive act --

JUSTICE SOUTER: Yes.

MR. GROSSMAN: That's correct.

JUSTICE SOUTER: Now, how many times are parties in the position of Respondents ever going to engage in those acts except with exactly the state of mind that on your judgment makes them principals, rather than aiders and abettors.

MR. GROSSMAN: It is not on my judgment. It has to be pled with the particularity required by the PSLRA.

JUSTICE SOUTER: No. No, I realize that you have to plead it. What I'm getting at is: Are you making a distinction that in the real world is not a distinction? That, in reality, no one is going to do what these Respondents did without the kind of knowledge or intent that makes them, on your theory, principals rather than aiders or abettors?

MR. GROSSMAN: There are cases, I think, Your Honor, where they can engage in deceptive conduct, and there would not be the purpose to defraud shareholders. For instance, Charter may have come to them and said look, do me a favor, says the sales manager. I want to make my numbers for this period so I can take my wife on a trip to Hawaii that the company will give me.

So the company gives him a phony order, thinking that's the purpose of it. That's the purpose

of this phony order to help this guy along.

Well, you've engaged in a deceptive act. It may be deceptive under 10(b), but you wouldn't satisfy the "purpose" test, because the purpose --

JUSTICE SOUTER: In other words, it's deceptive but not deceptive in relation to, or for the purpose of, deceiving the -- the petitioner.

MR. GROSSMAN: Right.

JUSTICE SCALIA: But don't aiders and abettors have to have that purpose as well? What distinguishes -- what distinguishes the liability that you propose from aider and abettor liability?

MR. GROSSMAN: You have to engage in a deceptive act under 10(b). 10(b)prohibits any deceptive act.

JUSTICE SOUTER: I thought you were telling me that in each case there may be a deceptive act but not a deceptive act in relation to somebody like the Petitioner here.

MR. GROSSMAN: Exactly.

JUSTICE SOUTER: But that's a different answer, I think, from the one you were just giving Justice Scalia.

MR. GROSSMAN: No. I -- I understood, perhaps mistakenly, from Justice Scalia that there

wasn't a deceptive act in your hypothetical. If there is a deceptive act, then it's prohibited by 10(b), and we move to the next statute --

JUSTICE SCALIA: So any aiding and abetting through a deceptive act makes you a principal? Is that it? You can't be an aider and abetter by committing or enabling a deceptive act without becoming a principal.

MR. GROSSMAN: No. Not At all.

JUSTICE SCALIA: You cannot --

MR. GROSSMAN: You, yourself -- you, yourself, have to engage in the deceptive act.

JUSTICE SCALIA: Yes.

MR. GROSSMAN: Your own deceptive act.

JUSTICE SCALIA: Yes, but -- but if you do, or if you should have known, you are not an aider and abetter. You are automatically a principal.

MR. GROSSMAN: You may be a principal if you satisfy the other elements of our test, which are serious elements that you have to plead with particularity, with the heightened pleading standards, that they have the purpose to further a scheme to defraud. That's very different --

JUSTICE SCALIA: Is it fair to say that all aiders and abettors who commit deceptive acts are principals?

MR. GROSSMAN: No.

JUSTICE SCALIA: What's the difference? What separates the two?

MR. GROSSMAN: You have to take it the next step further, whether or not that deceptive act had the purpose and effect for furthering a scheme of an investor.

JUSTICE SCALIA: Don't you need that to be an aider or abetter?

MR. GROSSMAN: An aider and abetter? You have to have --

JUSTICE SCALIA: What if -- if I'm entirely innocent, and I don't --

MR. GROSSMAN: An aider -- certainly -- certainly, the primary violator in the situation that we are discussing where there are deceptive acts is aiding and abetting.

If an accountant comes in and deliberately falsifies a financial statement, he is giving substantial assistance to the company's statement through the company who is issuing those false statements. He would be an aider and abetter in that sense. He is also a primary --

JUSTICE SCALIA: You see, I really thought the difference was that the principal is the one who

makes the deceptive representation and obtains money from it. The aider and abetter is the person who facilitates or enables that deceptive representation, which is what we have here.

And you say if you facilitate knowingly and intentionally or even grossly negligently, you are not an aider and abetter, but you're a principal. I really don't understand what's the line between the two.

MR. GROSSMAN: If you facilitate with a deceptive act, then you're a primary violator. That's what Section 10(b) prohibits. If you facilitate without a deceptive act, then you are an aider and abetter.

JUSTICE GINSBURG: Mr. Grossman, before you finish, there is one statement made by the other side that you are trying to use this -- small in comparison to all the fraud that was involved here in order to collect on the entire loss. That is, you are asserting that the vendors are liable for the entire loss when they were just a bit player.

MR. GROSSMAN: Yes. We are not seeking that at all, Your Honor. We -- the PSLRA proportionate liability provisions govern this with respect to --

JUSTICE GINSBURG: So what are you seeking? How would you measure your damages?

MR. GROSSMAN: We would measure the damages,

number one, that flow from this particular scheme. We would have to first subtract the settlements that we've achieved already, and then the proportionate liability provisions of the PSLRA provide how you make this determination.

You look at the particular nature of their conduct, and you look at the extent to which their particular conduct had a causal relationship with the damages.

CHIEF JUSTICE ROBERTS: Mr. Grossman, I'm conscious of eating into your time but a question -- how many chains of this connection can you have? Let's say Charter was not a publicly traded company, but same thing happened with respect to Scientific-Atlanta, and that made it look valuable to a company that is publicly traded. So they decided to buy Charter and then that made their profits look better to investors. Can you -- how many chains in the link can you go?

MR. GROSSMAN: Well, I -- I think you can go so long as the person's deceptive conduct has the purpose for furthering a scheme to defraud. If they engage in some deceptive conduct that was not in furtherance of the scheme to defraud, that's another thing. I --

CHIEF JUSTICE ROBERTS: Thank you,

Mr. Grossman.

MR. GROSSMAN: Thank you, Your Honor.

CHIEF JUSTICE ROBERTS: Mr. Shapiro.

ORAL ARGUMENT BY STEPHEN M. SHAPIRO.

ON BEHALF OF THE RESPONDENTS

MR. SHAPIRO: Thank you, Mr. Chief Justice, and may it please the Court:

My friend has just asked the Court to expand an implied cause of action by diluting traditional requirements such as the reliance requirement and by eroding this Court's precedent in the Central Bank case.

The Court has said in the past that it must be very cautious about expanding implied causes of action, but here there are special reasons for caution. Expanding the implied cause of action would give plaintiff the very thing that Congress said it should not get in Section 20(e) of the Exchange Act.

Congress wanted cases like this one to be handled by an expert and disinterested administrative agency.

JUSTICE GINSBURG: That's if you equate this with aiding and abetting, and I think the question is -- is there a middle category between Charter, who is clearly primarily liable, and Central Bank, that didn't do anything deceptive?

MR. SHAPIRO: The Central Bank case, I believe, answers that by saying to be a primary violator you have to satisfy all the prerequisites of 10(b) liability, including reliance, loss causation, the "in-connection-with" standard. And here plaintiffs fail to meet these tests. And Congress in 20(e) --

JUSTICE GINSBURG: But you are saying -- I thought your argument, unlike the government's argument, is that there was no deceptive device. There was no deceptive device. They simply aided and abetted.

MR. SHAPIRO: Yes. That's one of the arguments we make. It is that this case is governed by Central Bank because the defendant did not use or employ deception in connection with a securities transaction. That exactly describes what Charter did.

Now, what exactly describes what the vendors are alleged to do is what is said in 20(e) -- to knowingly give substantial assistance to someone else that is misleading an investor. That fits this case like a glove where --

JUSTICE KENNEDY: I agree with Justice Ginsburg. I thought the "in-connection-with" argument is actually in addition to or separate from an additional argument you made that there was no deceptive statement made here. I thought that's what you were

arguing, and I have problems with that argument because the statute doesn't require a statement. It requires government conduct to suffice.

MR. SHAPIRO: We don't make these arguments without reference to each other. We think all of these statutory terms have to be viewed together. You have to use deception in connection with securities trading, which these vendors did not do. That's what Charter did. And we --

JUSTICE KENNEDY: Would you say there was deception, standing alone?

MR. SHAPIRO: Well, we have -- we have suggested that that is not true when you're speaking with somebody that knows the facts such as Charter. Charter understood all these facts. Charter could have accounted for these transactions correctly, itself. The vendors did that. They didn't recognize any revenues here. It was up to Charter to account for these transactions properly. Congress required it to do that, so it is the speaker here.

JUSTICE GINSBURG: But Charter said -- vendors, I need you to consummate this fraud on the public. I can't do it without you. I've got to have those revenues that you're going to give me through these phony advertising payments at four or five times

the usual rate.

MR. SHAPIRO: Well, we believe even placing that most pejorative characterization on these facts, which we don't agree are the true facts, that still --

JUSTICE GINSBURG: But you must assume that they are now.

MR. SHAPIRO: Assuming that they are, that this is a 20(e) situation where it is alleged that the vendors gave substantial, knowing assistance to somebody who was committing a fraud. And Congress said that an expert and disinterested administrative agency should decide whether to proceed, because it is so slippery to apply these characterizations.

JUSTICE GINSBURG: That's if they are -- that's if they are aiders and if there are only two categories and everyone who is not Charter is an aider and abettor, then you're right. But if there's a middle category of people who, while not the benefited company -- the company that's trying to achieve the deception -- but made it possible for that -- for that deception to happen.

MR. SHAPIRO: Well, you know that's an exact description of Central Bank because there it was alleged that the trustee entered --

JUSTICE GINSBURG: No --

MR. SHAPIRO: -- into a secret agreement.

JUSTICE GINSBURG: In Central Bank, it was conceded that the bank engaged in no deceptive act.

MR. SHAPIRO: Well, the --

JUSTICE GINSBURG: Here there is the charge that it did engage in deceptive acts.

MR. SHAPIRO: What was conceded was that the bank made a misstatement to investors, but what was alleged in the complaint and argued in the briefs was that the bank entered into a secret side agreement that enabled the use of a fraudulent prospectus that unleashed securities that were worthless on investors, and investors said, we were depending on our trustee to prevent that from happening.

JUSTICE SOUTER: Now, I take it, though, you do not defend the position that there must -- for 10(b) liability, that there must have been a statement addressed to investors.

MR. SHAPIRO: Well, we -- we think that for reliance purposes, there --

JUSTICE SOUTER: Well, do you --

MR. SHAPIRO: -- the defendant has to communicate with investors.

JUSTICE SOUTER: Would you answer my question first? Do you take the position that there can

be no 10(b) liability without a statement addressed to investors?

MR. SHAPIRO: It has to be communicated to the investors and it has to be attributed under the case law to the --

JUSTICE SOUTER: You mean the statement as such or a statement which could not have been made but for the statements of the Respondents must be communicated to the investors? Which one?

MR. SHAPIRO: That -- that kind of but-for causation is not sufficient. That is not reliance. That kind of --

JUSTICE SOUTER: So are you -- so you are saying that there can be no causation and hence, you know -- and I think you're going further. You're saying there can be no liability within the description of 10(b) unless there is a statement directly addressed to the investors, is that correct?

MR. SHAPIRO: That is one of our submissions, but we also say that the substance of these statements was never communicated to investors. Only Charter --

JUSTICE GINSBURG: Because the whole purpose of it --

MR. SHAPIRO: -- spoke to the investors and

never summarized these.

JUSTICE GINSBURG: Mr. Shapiro, if --

MR. SHAPIRO: Yes?

JUSTICE GINSBURG: If it was communicated to investors that there had been $20 per set box over the regular price, if there had been advertising that was paid for by the very money that Charter gave, then the whole thing would have failed. So this can work only if the vendors are silent. Silence and not speech is what counts. If the vendors communicate anything at all, the whole thing fails.

MR. SHAPIRO: But the -- the communication, Your Honor, has to be to the market and to investors. There was no duty to disclose to investors here. The only communications the vendors made were we're raising our prices 6 percent, the date of our contract is August 31st, for the simple reason that it started the very next day --

JUSTICE GINSBURG: Was there any --

MR. SHAPIRO: -- on September 1st.

JUSTICE GINSBURG: Was there any economic substance to this?

MR. SHAPIRO: Oh, of course. There was economic substance from the vendors' perspective. They were selling their products at exactly the price that

they wanted to receive for those products and they were getting some free cooperative advertising thrown in at the same time.

JUSTICE GINSBURG: Is it true that the price that they were charging, they did not charge to other customers -- the $20 hike?

MR. SHAPIRO: Well, it's true because they weren't concerned with that because they weren't paying for it. Charter was paying for this cooperative -- cooperative advertising, the reason being --

JUSTICE GINSBURG: But it was --

MR. SHAPIRO: -- that Charter had a big interest.

JUSTICE GINSBURG: -- a sham then, because they said the reason they upped the price $20 a box was they -- the inflationary conditions, so they had to renegotiate the contract, but didn't renegotiate with any of their other customers.

MR. SHAPIRO: Well, Your Honor, from the vendors' perspective, this was a transaction that appeared to be a way to increase cooperative advertising. It cost the vendors no money. They were told by Charter that Arthur Andersen had approved the transaction. That's alleged in the Barford indictment. Then they went home and talked to their own auditors --

how could you account for this transaction? The auditors said, you cannot record any revenues from the transaction. They didn't record any revenues. They expected Charter to do the same thing, to not record revenues --

JUSTICE KENNEDY: But that's --

MR. SHAPIRO: -- of that sort of thing as required.

JUSTICE KENNEDY: That's not the allegation of the complaint. I -- I thought the allegation of the complaint was that they -- they knew that this was a fraud and they participated in the fraud.

MR. SHAPIRO: Yes, they -- they do allege. I'm merely pointing out that in the --

JUSTICE KENNEDY: But I mean that -- so that your answer doesn't seem to be at -- on a legal point.

MR. SHAPIRO: Well, we say that if you take the complaint at face value and you don't even consider the Barford indictment that they cite, that it still is a classic example of knowingly giving substantial assistance to someone else that is making misstatements to investors, because these vendors didn't make any misstatement to investors. Nobody relied on their sales correspondence. It sat in a file drawer until long after the stock had gone all the way up and come all the

way down.

JUSTICE GINSBURG: That's the essence of the scheme. You said that they -- they are home free because they didn't themselves make any statement to investors. But they set up Charter to make those statements, to swell its revenues -- revenues that it in fact didn't have.

MR. SHAPIRO: But Congress's policy judgment here is that the SEC, an expert agency that is impartial, should evaluate a claim of that sort and decide whether to proceed.

JUSTICE GINSBURG: That's if they are aiders and abettors, which is what Congress covered. And I again go back to, is there another category or is everyone -- either Charter, the person whose stock is at stake, the company whose stock is at stake and everyone else is an aider? I take it that that's your position.

MR. SHAPIRO: Well --

JUSTICE GINSBURG: It's either the company whose stock is in question or you're an aider and abettor.

MR. SHAPIRO: You are only a primary violator under -- under Central Bank if each and every element of 10b-5 liability is satisfied, including reliance on your statement, including the

"in-connection-with" test, and including loss causation. None of those tests are satisfied here, but what is satisfied is Section 20(e), which says, did they knowingly give substantial assistance to somebody who is committing a fraud? And that -- that fits this case like a glove --

JUSTICE KENNEDY: If we accept --

MR. SHAPIRO: -- if Congress wanted the SEC to address --

JUSTICE KENNEDY: If we accept your theory of the case and we then get another case in which an accountant or an attorney who prepares the statement for publication to the investors and then gives it to Charter, and they are before us, could we find liability under 10b-5 as to the accountants and still rule -- and still keep our ruling in favor of your client here?

MR. SHAPIRO: It really depends on --

JUSTICE KENNEDY: And if so, what would --

MR. SHAPIRO: -- on the circumstances.

JUSTICE KENNEDY: And if so, what would be the rationale?

MR. SHAPIRO: Some attorneys are control persons within corporations, and in-house counsel that drafts the disclosure statement which contains a falsehood may be liable as in the Macondua case, which

the Court recently considered. Individuals may be liable --

JUSTICE KENNEDY: How about outside accountants and attorneys who deliberately and directly participate in negotiating -- or in drafting the false disclosure statements?

MR. SHAPIRO: I --

JUSTICE KENNEDY: Could they be liable and under your theory of the case, but your client not liable?

MR. SHAPIRO: It -- it's possible. Your Honor, at the end of your --

JUSTICE SOUTER: Well what about in this case? Let's be specific. As I understood an earlier answer of yours, the answer was that Arthur Andersen knew what was going on. If I've -- if you are -- as I understand it, that's not what was charged, but if that's correct, Arthur Andersen did know what was going on. Can Arthur Andersen be held liable under 10b-5 --

MR. SHAPIRO: Absolutely --

JUSTICE SOUTER: -- whereas your client cannot?

MR. SHAPIRO: Yes, sir. The reason --

JUSTICE SOUTER: And the difference is?

MR. SHAPIRO: The reason is they issued

opinions that were circulated to investors, that were attributed to them and which were authorized by them, and if a lawyer does the same thing, if Steve Shapiro writes an opinion letter and circulates it to investors and it's full of falsehoods --

JUSTICE SOUTER: But --

MR. SHAPIRO: -- I can be held liable for that --

JUSTICE SOUTER: What if Arthur Andersen --

MR. SHAPIRO: -- as a speaker.

JUSTICE SOUTER: What if Arthur Andersen has a footnote in there saying, this is okay because we have this -- this letter from I forget which one of the two Respondents it was, saying there's been inflation and therefore we've got to renegotiate the prices and jack them up 20 percent, Arthur Anderson knows that that is false and the Respondent who made it knows that it is false, can the Respondent who made it then be held liable?

MR. SHAPIRO: Only people who speak to the market --

JUSTICE SOUTER: Yes, but doesn't --

MR. SHAPIRO: -- and induce investor reliance.

JUSTICE SOUTER: Yes, but doesn't -- doesn't

the Respondent in that case know that it is likely that the auditor is going to indicate the basis for its statement, that the transaction is okay --

MR. SHAPIRO: Well --

JUSTICE SOUTER: -- and, therefore, isn't it reasonable to suppose that they anticipated that their statement would be communicated to the market?

MR. SHAPIRO: That is just aiding and abetting, and in fact Congress dealt with that squarely in Section 303 --

JUSTICE SOUTER: But there's a communication to the market --

MR. SHAPIRO: Oh, yes --

JUSTICE SOUTER: -- and there's a reason to expect that communication.

MR. SHAPIRO: Yes.

JUSTICE SOUTER: Doesn't that make any difference?

MR. SHAPIRO: That's not sufficient. Congress addressed that in Section 303 of Sarbanes-Oxley, and it held that any person -- said any person including a vendor that misleads an auditor can be held liable in an SEC proceeding only, not in a private suit. It excluded private actions.

JUSTICE SOUTER: Is the word "only" in

there?

MR. SHAPIRO: Pardon me?

JUSTICE SOUTER: Is the word "only" in there?

MR. SHAPIRO: The word "exclusively" is in there --

JUSTICE SOUTER: In the statute?

MR. SHAPIRO: -- and my --

JUSTICE SOUTER: So you have an independent defense quite apart from -- from the construction of 10b-5?

MR. SHAPIRO: We rely on 20(e) and 303 of Sarbanes-Oxley, and my friend has made the argument --

JUSTICE GINSBURG: Which I thought speak about aiders and abettors.

MR. SHAPIRO: It's talking about an aider and abettor that misleads an auditor and then --

JUSTICE GINSBURG: But they usually --

MR. SHAPIRO: -- the auditor issues a false certification.

JUSTICE GINSBURG: -- aider and abettor -- then again we get back to the question: If there's nothing in this world other than the company that puts out the false statement and the aider and abettor --

MR. SHAPIRO: Well -- oh, no --

JUSTICE GINSBURG: -- and is there something in between?

MR. SHAPIRO: Your Honor, there are other persons that are control persons within a company who are liable.

JUSTICE GINSBURG: We're taking those out. We're taking about independent actors.

MR. SHAPIRO: Independent actors that don't speak to the markets and cause direct reliance on their statement are aiders and abetors. And they are supposed to be dealt with by the SEC, an expert agency.

Now, my friend made the argument about Sarbanes-Oxley that there's a savings clause in that provision that preserves other remedies. But if you look at the legislative history, it says explicitly we are preserving SEC remedies. We want the SEC to pursue these suits. And Congress refused in 2002 in Sarbanes-Oxley to reinstate the aiding and abetting private liability clause.

JUSTICE KENNEDY: Do you know, Mr. Shapiro, if in the law of torts and the restatement of torts or in other areas of the law there is some third classification that's between aider and abettor in principle?

MR. SHAPIRO: I don't know the answer.

Although in these statutes themselves there are such provisions not included in Section 10(b). For example in Section 18(a), if you cause some other person to make a false statement in a financial statement, you can be held liable, but they are not invoking it in Section 18. Same thing under Section 17. If you engage in a scheme to cause some falsehood, you can be prosecuted by the government.

But nowhere has Congress said that an individual litigant can bring a claim like that without regard for reliance and in connection with in the loss causation test.

JUSTICE SOUTER: Let's assume there is reliance and loss causation. Let me ask a question very similar to what Justice Ginsburg has posed a couple of times. She has said is there a third category. My question is, is there an overlap? Can there be an overlap?

MR. SHAPIRO: No, I don't there can be.

JUSTICE SOUTER: Why?

MR. SHAPIRO: Because Congress intended in Section 20(e) to have an expert agency to address these cases and not to have the trial --

JUSTICE SOUTER: Congress intended an expert agency to address solely aiding and abetting cases. My

question is if there is an overlap -- A, can there be an overlap? And if so, I don't see why Congress' intent to reserve aiding and abetting alone to the agency affects the determination of this case.

MR. SHAPIRO: We believe they are separate categories and that Central Bank tells us exactly who the primary violator is. He is somebody who makes a statement that investors rely on in connection with securities transactions, and that is not these vendors. That is exactly what Section 20(e) addresses and commits --

JUSTICE SCALIA: Could you amend that to say -- you don't insist that he make a statement that invest -- he could engage in a deceptive practice directed at investments?

MR. SHAPIRO: Absolutely. Absolutely. We don't quarrel over that, Justice Scalia.

JUSTICE SOUTER: For example, for example, let's assume in this case that Charter said we've, we've got to let the investors know that our cost of doing business is going up, and we want to you make an announcement that you're jacking up your price 20 percent. In that case there would be primary liability.

MR. SHAPIRO: Absolutely.

JUSTICE SOUTER: Why in that case is there

not also aiding and abetting? We know perfectly why they are doing it, and they are doing it solely to aid and abet Charter in its scheme themselves enjoying a wash transaction. Why isn't that both primary and aiding and abetting?

MR. SHAPIRO: Well, it's primary because there is communication of the market that's missing here.

JUSTICE SOUTER: We know it's primary. Why isn't it also aiding and abetting?

MR. SHAPIRO: You can call it --

JUSTICE SOUTER: If you can call it, why isn't there the kind of overlap which raises the question that Justice Ginsburg has raised?

MR. SHAPIRO: You can't have primary liability, which they are asserting here, without the statement to the market. And it can be a statement by conduct, and it can be by nodding of the head.

JUSTICE SOUTER: So you are saying there can be an overlap but there is no overlap that helps the Petitioner in this case?

MR. SHAPIRO: Oh, yes. Nodding the head is the same thing as saying yes. But it has to be made directly to an investor and cause reliance by that investor. That's what's missing here.

So there is nothing wrong with the Eighth Circuit's decision. It didn't address that refinement, because it has no bearing on this case. So there is no point in reversing the decision. It has to be affirmed in our view for want of reliance, for want of loss causation, for lack of in connection with, and because most importantly, Congress intended to remove this category of case and commit it to an expert agency as part of its very important reform effort to deal with excessive litigation that was harming our economy.

This is an important concept for Congress. And it said it twice: First in the PSLRA in 1995, then in 2002, in the Sarbanes-Oxley law. And it removed even claims that you mislead an auditor under Section 303 of Sarbanes-Oxley. And there is no savings clause there for private actions. Congress refused to permit the private actions.

Instead, it permitted the SEC to bring intentional misconduct cases under Section 20(e) or negligent misconduct cases under Section 303 or under Section 13. And the SEC has a broad panoply of remedies. It doesn't have to just allege intentional --

JUSTICE GINSBURG: Does the SEC distinguish this kind of situation where silence is the essence of the thing for the deceiver, silence not speech? Does

the SEC distinguish this from aiding and abetting?

MR. SHAPIRO: Well, the SEC's view is the one rejected by the Solicitor General, and that's this purpose and effect standard that's been advocated, which we think is hopelessly vague. And it overrides the reliance requirement. It overrides in connection with requirement. And it overrides loss causation.

JUSTICE STEVENS: Mr. Shapiro, what is your strongest case, in your view, for the reliance requirement?

MR. SHAPIRO: Central Bank itself.

JUSTICE STEVENS: Central Bank itself?

MR. SHAPIRO: Yes. Because the court there said that even though the bank did something that was a secret agreement that facilitated the issuer's distribution of a false prospectus and caused all the harm to the shareholders, it was the direct sine qua non cause of all of that harm. That that was aiding and abetting, because there was no reliance on anything that the bank stated or anything that the bank had a duty to state because of a fiduciary relationship.

Now, the vendors here are even far more removed from investors than the bank was in Central Bank. The investors knew about the bank in Central Bank, and they were relying on it to do its job. But

that was not sufficient because it made no statement that the investors relied on it. There is no communication here between these vendors and investors. There is no way you could --

JUSTICE STEVENS: In your judgment, is the reliance private requirement an element of the violation or of the private cause of action?

MR. SHAPIRO: It's the private cause of action. An important point, Justice Stevens, because the SEC is not burdened with any of these elusive inquiries into but for causation, speculative questions of indirect reliance; none of that burdens the SEC.

And the SEC also has power to distribute funds to investors. This is the better mouse trap that Congress prescribed for these kinds of cases. It didn't want the trial lawyers to bring class actions that always result in settlements.

CHIEF JUSTICE ROBERTS: Thank you, Mr. Shapiro.

MR. SHAPIRO: We thank the Court.

CHIEF JUSTICE ROBERTS: Mr. Hungar.

ORAL ARGUMENT OF THOMAS G. HUNGAR
FOR UNITED STATES, AS AMICUS CURIAE,
SUPPORTING RESPONDENTS

MR. HUNGAR: Thank you, Mr. Chief Justice,

and may it please the Court:

The Court of Appeals erred to the extent it held that Section 10(b) applies only to verbal misrepresentations or omissions. But the Court correctly held that this Court's decision in Central Bank forecloses Petitioner's claim here. Like the plaintiff in Central Bank, Petitioner cannot establish reliance, a critical element of the Section 10(b) implied right of action.

Neither Petitioner nor the market relied on or was even aware of any deceptive conduct or statement by Respondents --

JUSTICE STEVENS: Mr. Hungar, I want to be sure I understand one part of the government's position. You do take the position that there has a violation of 10-b-5?

MR. HUNGAR: We haven't taken a position on that question, Your Honor. We take the position that there was deceptive conduct alleged. That's one of the elements of a 10-b-5 violation, but not the only element.

JUSTICE STEVENS: Were the other elements present?

MR. HUNGAR: As I say, we have not taken -- I mean, materiality, for instance, in connection with

requirements scienter we haven't addressed those questions and have not made --

JUSTICE STEVENS: Do you have an opinion as to whether there was a violation of 10(b) in this case?

MR. HUNGAR: No, Your Honor.

JUSTICE STEVENS: You don't have an opinion?

MR. HUNGAR: We haven't taken a position.

JUSTICE STEVENS: I know you haven't taken a position, but I was just wondering if you have an opinion?

(Laughter.)

MR. HUNGAR: No, Your Honor. We haven't addressed the other elements and those -- questions that we have -- because there is no need to resolve them in this case and because they weren't resolved by the court of appeals or by the district court, we have chosen to focus on what we think is dispositive and what was raised and decided below which is reliance --

JUSTICE STEVENS: You have not reached opinion as to whether there was a violation of the statute?

MR. HUNGAR: Correct.

JUSTICE SOUTER: Has the SEC publicly taken a position on that question?

MR. HUNGAR: I'm not sure of the answer to

that question, Your Honor. Certainly individual commissioners have given speeches and testified before Congress to the effect that the Commission voted in this case to agree with our position on deception, the position that's expressed in our brief, and by three to two vote to disagree with the position on reliance that is expressed in our brief. But I don't know that there has been any official SEC Commission statement to that effect that's been publicly released.

As I said, the only deceptive conduct that was allegedly committed by Respondents in this case involves the backdating of contracts and the false justifications for the price increase. That conduct was never disclosed to the market at any time during the class period, and therefore, could not have been relied on by the market or by Petitioners.

And as a consequence, under this Court's decisions in Central Bank and in Basic, reliance cannot be established because the presumption of reliance that Petitioner seeks to invoke requires as a prerequisite to its invocation the existence of a publicly disseminated statement from the defendant that was disseminated to and, therefore, relied on by the market. That did not happen here with respect to Respondents.

JUSTICE GINSBURG: Could SEC get any

monetary recovery for the investors on your theory? You say yes, it's a deceptive practice, but this belongs in the SEC's bailiwick, not in private suits?

MR. HUNGAR: Yes, Your Honor.

JUSTICE GINSBURG: Private suits; obviously they are seeking damages for the decline in the share price. What could the SEC -- suppose it should take up in this case -- get by way of remedy?

MR. HUNGAR: The SEC is entitled to obtain civil fines, as well as disgorgement remedies.

JUSTICE GINSBURG: But there is no disgorgement here because the vendors didn't get anything. For them it was a wash.

MR. HUNGAR: Well, I don't know -- I believe in the, not in this case but in the Adelphia, case which is addressed --

JUSTICE GINSBURG: Well this case, disgorgement would not be a remedy. You say fines, those would be payable to the Government, right?

MR. HUNGAR: If I may -- yes, yes and no, I think is the answer to that question; because under the fair funds provision of the Sarbanes-Oxley Act, Section 308 of Sarbanes-Oxley, the SEC is authorized to take fines and distribute those as -- those as disgorgement relief -- and distribute them to investors.

JUSTICE GINSBURG: But there would be no disgorgement relief.

MR. HUNGAR: Well, I'm not sure I can agree with that point. In the Adelphia matter --

JUSTICE GINSBURG: What profits did the vendors get? For them it was a wash. They got -- what did they have to disgorge?

MR. HUNGAR: Well, they obtained -- at least it appears that they obtained advertising that presumably had some value, although it didn't cost them anything; and presumably the SEC could seek the value of that advertising. As I said, in the Adelphia matter where the SEC did pursue the vendors that assisted Adelphia in a somewhat similar transaction, it obtained substantial monetary recoveries from them. I think --

JUSTICE GINSBURG: But did they receive something that they then disgorged?

MR. HUNGAR: I believe the allegations were similar to those here. But in any event, certainly the SEC has the authority to proceed in that fashion, and additionally the Justice Department has the ability to proceed criminally, and to obtain substantial monetary sanctions, either as part of a deferred prosecution agreement, as part of a restitutionary sanction and the like; but the fundamental point is that for the private

right of action to apply, as this Court said in Central Bank, all of the elements of the private cause of action must be satisfied with respect to the individual defendant. That is the line.

CHIEF JUSTICE ROBERTS: Do you agree, do you agree with Mr. Shapiro, what I understood to be his argument, that 20(e), the aider and abettor statute, more or less occupies the field here and there is no role for additional 10b-5 liability.

MR. HUNGAR: Well, I wouldn't say it occupies the field per se, but what it does do is -- given the timing of this Court's decision in Central Bank in 1984 followed by Congress's considering the question and whether to provide for secondary liability in private acts, and its decision not to authorize such secondary liability -- what it does clearly suggest is that this Court ought not adopt the expansive view of the implied right of action that Petitioner is urging, but instead both because the Court is appropriately cautious in expanding liability under implied rights of action, and because Congress has now looked at this question, not once but twice, and has declined to provide secondary liability for secondary actors under the cause of action.

JUSTICE SCALIA: You think that you are

either a principal or an aider and abettor?

MR. HUNGAR: You can, it's possible for someone to be both but in order to be both they must have -- they must have satisfied all of the elements.

JUSTICE SCALIA: For the same act, I'm talking about -- for the same act.

MR. HUNGAR: Yes. For instance an auditor who certifies false financial statements and allows that -- its certification to be, to be publicly disseminated, thereby aiding and assisting in the issuer's primary fraud, but is also a -- quite likely to be a primary violator, because they have spoken to the market. The market is relying on their statements, and is aware that they are making them; and so they would be both a primary violator, but presumably could be pursued as an aider and abettor. I don't think there is any preclusion of liability under both, but in order to be in that category you must be a primary violator. And here, Petitioners have not established and cannot establish the reliance element with respect to Respondents, because nothing that Respondents said or did was disseminated to the market during the class period.

JUSTICE KENNEDY: And I take it in your view tney cannot establish the -- in connection with

argument. There is no reliance, but that there is in connection --

MR. HUNGAR: Your Honor, I would hesitate to say that, Your Honor, because the SEC and the United States do not have to establish reliance in criminal or civil enforcement proceedings, but we do have to establish in connection with, and we think they are different. We think reliance adds something more than what in connection with requires, and so I certainly would urge the Court not to suggest that merely because reliance is not established, therefore in connection with must not also be established; and that is one of the reasons that we think that in connection with question was resolved, not in this case, but in the case where it's been squarely presented, and/ preferably a Government enforcement action where the Government has an opportunity to tailor the case in an appropriate fashion.

The Court, as I said has been --

CHIEF JUSTICE ROBERTS: It's at least a little awkward for you to say we should wait for a case in which it's been fully presented when the argument you're presenting here wasn't fully presented or at least was not decided below.

MR. HUNGAR: I think it was, Your Honor. It

was certainly briefed and argued in both the district court and the court of appeals. The district court squarely resolved -- it's at page 41a of the Petition appendix. The court of appeals addressed reliance at page 10a of the Petition appendix. It did not give it a fully orbed discussion.

CHIEF JUSTICE ROBERTS: I -- the court of appeals decision would be based on its determination that there was no deceptive act because there was no statement or omission.

MR. HUNGAR: But on page 10a, they also talk about reliance, Your Honor; and what's important here to understand is that the Petitioner's theory of reliance rests on a misstatement, because they say it's a market -- it's a basic presumption of reliance based on the fraud in the market theory case. That's the only allegation of reliance in the complaint; that requires something that was publicly disseminated. The only thing that was publicly disseminated is the statement, but the court of appeals said that doesn't work, and there was no reliance because Respondents didn't make any publicly disseminated statement. So it's actually, perhaps not a complete, but certainly a perfectly reasonable resolution of the reliance question; and therefore it is squarely presented. Petitioners has

raised reliance in their petition --

JUSTICE GINSBURG: I don't see --

MR. HUNGAR: -- at page 25. In their opening brief at pages 37 to 40, it's squarely presented and --

JUSTICE GINSBURG: I'm looking at the court of appeals decision which I thought just said that there was no deceptive device.

MR. HUNGAR: Your Honor, on page 10a, the second line, the first full sentence, speaking of Motorola and Scientific-Atlantic, "they did not issue any misstatement relied upon by the investing public," and then it goes on the next sentence: "None of the alleged financial misrepresentations by Charter was made by or even with the approval of the vendors," that is the Respondents.

Again as I say, it's not as complete a discussion of the reliance issue as we would have thought appropriate if we had been writing the opinion, but it certainly does touch on the question and we think it's wholly presented.

CHIEF JUSTICE ROBERTS: Thank you, Mr. Hungar.

Mr. Grossman, have you three minutes.

REBUTTAL ARGUMENT OF STANLEY M. GROSSMAN

ON BEHALF OF THE PETITIONER

MR. GROSSMAN: Thank you.

I -- excuse me, I have three quick points to make.

One, Mr. Shapiro and Mr. Hungar both said that the advertising cost the vendors no money. Well, if the advertising cost them no money, why was there a contract that they entered into for the purchase of advertising? Clearly it was designed to give the false appearance that Charter had this additional $17 million in revenue.

Number two, the SEC did take a position in the Simpson case as it submitted an amicus brief, the commissioners testified before a House committee this past spring that they wanted to submit the same brief on the same points supporting the position that we are taking here; and the testimony of Commissioner Cox is appended to the briefs of Congressmen Franks and Conyers.

Number three, Central Bank did not turn on reliance. Central Bank turned on the issue of deceptive conduct. There was no deceptive conduct in that case. The plaintiffs conceded there was no deceptive conduct; the court of appeals and the district court said there was no deceptive conduct; it was strictly an aiding and

abetting case.

With respect to the reliance issue in Central Bank, what the Court did say was under plaintiff's theory he wouldn't have to prove reliance. He only had to prove that he, that the defendant substantially assisted a defendant who engaged in a primary violation, but he would not have to prove any reliance by the aiding and abettor.

Number three, with respect to 20(e), how do my friends on the other side read 20(e) in connection with Section 9 and Section 18 of the Exchange Act, each of which provides remedies and private rights of actions against multiple parties? Under their definition, that would appear to be displaced by 20(e). 20(e) was not designed, it was not intended to do anything but to give the SEC the right to bring the very type of aiding and abetting action that this Court barred in Central Bank.

CHIEF JUSTICE ROBERTS: Thank you, Mr. Grossman. The case is submitted.

(Whereupon, at 12:00 p.m., the case in the above-entitled matter was submitted.)

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